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Built-in Gain Discounts for Transfer Tax Valuation: A Resolution for the BIG Debate

Scott Andrew Bowman

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**BUILT-IN GAIN DISCOUNTS FOR TRANSFER TAX VALUATION:
A RESOLUTION FOR THE BIG DEBATE**

*Scott Andrew Bowman**

- I. Introduction 117
- II. Transfer Tax Valuation of Closely-Held Entities..... 119
- III. Development of the Built-in Gain Discount..... 128
 - A. Built-in Gain Discounts under the General Utilities Doctrine 128
 - B. Repeal of General Utilities and the Rise of the Built-in Gain Discount..... 132
 - C. The Current Debate..... 138
- IV. A Modified Liquidation Test..... 144
 - A. Conceptual Foundation 144
 - B. Determining the Incentive to Liquidate 146
 - C. Calculating the Built-in Gain Discount 163
 - D. Further Considerations..... 167
- IV. Conclusion 173

I. INTRODUCTION¹

Courts have long struggled with whether and to what extent for transfer tax purposes the value of gratuitously transferred shares in closely-held C corporations² should be discounted to reflect the potential

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1. Unless otherwise stated, all statutory citations are to the Internal Revenue Code (the “Code”) of 1986, as amended, and to the Treasury Regulations thereunder, as amended.

2. A C corporation is a corporation as defined in I.R.C. § 7701(a)(3) that has not made an election under I.R.C. § 1362(a) to be treated as an S corporation. See I.R.C. § 1361(a). A corporation is closely-held when its stock is owned by a relatively few number of shareholders, many of whom are often related parties.

tax liability that a corporation would incur from the recognition of built-in gain³ in its underlying assets. This discount is known as the built-in gain discount. In the most recent appellate decision on the issue, *Estate of Jelke v. Commissioner*,⁴ the estate argued that the value of the C corporation stock included in the decedent's gross estate should be discounted by the full amount of any built-in gain tax liability.⁵ The Court of Appeals for the Eleventh Circuit agreed with the estate.⁶ It granted a "dollar-for-dollar discount" by reducing the corporation's fair market value by the entire amount of tax liability that would be incurred if the corporation sold the underlying assets on the valuation date.⁷ In so doing, the Eleventh Circuit relied on two cases from the Court of Appeals for the Fifth Circuit, *Estate of Jameson v. Commissioner*⁸ and *Estate of Dunn v. Commissioner*.⁹ As explained below, *Estate of Dunn* and *Estate of Jelke* present problematic rulings that future courts should decline to follow.¹⁰

This article considers whether and to what extent courts should permit a built-in gain discount. It begins by presenting the challenges of valuing assets for transfer tax purposes, discussing the general principles of transfer tax valuation, and highlighting the particular methodologies used to value closely-held entities. The article then examines how,

3. Built-in gain is a taxpayer's unrealized appreciation in property. It is the I.R.C. § 1001(a) gain realized that a taxpayer would incur on a hypothetical sale of the property, calculated by using as the I.R.C. § 1001(b) amount realized the property's fair market value and as the I.R.C. § 1011(a) adjusted basis the taxpayer's actual basis, both determined as of the date of the hypothetical sale. For the discussion that follows, the character of the built-in gain would generally be capital gain. See I.R.C. § 1221. However, where the gain is triggered at the corporate level, the preferential I.R.C. § 1(h) capital gains rates would not apply. Accordingly, as it relates to corporate level gain, the distinction between capital gain and ordinary gain is ignored unless otherwise stated.

4. *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007), *rev'g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008). See *infra* text § III.C. Shortly after the Supreme Court's denial of certiorari on the *Estate of Jelke* appeal, Judge Swift of the Tax Court issued his opinion in *Estate of Litchfield v. Commissioner*, which concerned the amount of the built-in gain discount in a closely-held C corporation and a closely-held S corporation. 97 T.C.M. (CCH) 1079 (2009). See *infra* note 245.

5. *Estate of Jelke*, 507 F.3d at 1319.

6. *Id.* at 1333.

7. *Id.* at 1320, 1333.

8. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001), *rev'g*, 77 T.C.M. (CCH) 1383 (1999). See *infra* text § III.C.

9. *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002), *rev'g*, 79 T.C.M. (CCH) 1337 (2000). See *infra* text § III.C.

10. See *infra* text §§ III and IV.

during the era of the *General Utilities* doctrine,¹¹ a prospective liquidation test, which considered the prospect and affect of liquidation, led courts to repeatedly disallow the built-in gain discount. However, since the repeal of the *General Utilities* doctrine, the prospective liquidation test has been discarded, at least in part, and courts have become receptive to allowing the discount. The article considers the current debate, which the Supreme Court has declined to resolve,¹² and analyzes the holdings in three prominent court of appeals cases,¹³ the Tax Court opinions these cases overruled,¹⁴ and the parties' underlying arguments. The article demonstrates that the decisions in *Estate of Dunn* and *Estate of Jelke* relied on a problematic assumption—namely, that the corporation being valued is deemed liquidated on the valuation date.¹⁵ The article exposes that this assumption may lead to inaccurate outcomes in future cases. To avoid such results, the article proposes a modified liquidation test, which would yield a more accurate calculation of the built-in gain discount.

II. TRANSFER TAX VALUATION OF CLOSELY-HELD ENTITIES

Accurate valuation of gratuitously transferred assets is critical to the implementation of the transfer tax regime.¹⁶ Each transfer tax uses the value of the transferred property as the base upon which the tax is calculated.¹⁷ This value is determined as of the relevant valuation date,

11. See *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

12. *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007), *rev'g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008).

13. *Id.* at 1317; *Estate of Dunn*, 301 F.3d at 339; *Estate of Jameson*, 267 F.3d at 366. There is also a fourth relevant, though unpublished, opinion. See *Estate of Welch v. Comm'r*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. 2000) (unpublished table decision) (discussed *infra* notes 156 and 188).

14. *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) 1397 (2005); *Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337 (2000); *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383 (1999).

15. *Estate of Jelke*, 507 F.3d at 1331; *Estate of Dunn*, 301 F.3d at 353.

16. The transfer tax regime consists of the estate tax, the gift tax, and the generation-skipping transfer ("GST") tax. See Subtitle B of the Internal Revenue Code: Chapter 11 (estate tax), Chapter 12 (gift tax), and Chapter 13 (generation-skipping transfer tax). Chapter 14, also a part of the transfer tax regime, provides special rules on valuation that are not relevant to the present discussion; Chapter 15, also a part of the transfer tax regime, imposes a transfer tax on covered gifts and bequests from U.S. expatriates.

17. See I.R.C. § 2031(a) (including in gross estate the value of decedent's property); I.R.C. § 2512(a) (stating amount of gift is the value of the transferred property); I.R.C. §§ 2621 – 2623 (subjecting to GST tax the value of property received by the transferee); see also RICHARD B.

which is generally the date of the transfer.¹⁸ Because lower valuation results in less transfer tax liability, taxpayers often seek to minimize the value of gratuitously transferred property.¹⁹ The value of the transferred property is a function of two determinations. First, the undiscounted fair market value of the transferred property must be ascertained. Second, a decision must be made as to whether the undiscounted fair market value should be reduced by any valuation discounts, and, if so, the amount of those discounts.

To determine the undiscounted fair market value, transfer tax valuation begins with fundamental rules. Fair market value is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”²⁰ This willing buyer-willing seller test is well established,²¹ and its facets and implications have been widely developed in case law.²²

Three important characteristics of the willing buyer-willing seller test are evident from the Regulations. First, fair market value arises from the willingness between a hypothetical willing buyer (the “HWB”) and a hypothetical willing seller (the “HWS”) (collectively, the “hypothetical parties”) to enter into the transaction. The willing exchange contemplates a market bargain where the HWS is free to make known the availability of the goods and the HWB is able to shop for the

STEPHENS, ET AL., FEDERAL ESTATE & GIFT TAXATION ¶ 14.05[1], at 14-12 to 14-15 (8th abr. ed. 2008) (discussing methods of GST tax valuation).

18. See I.R.C. § 2031(a) (valuing gross estate as of decedent’s date of death); I.R.C. § 2512(a) (valuing gift at time of transfer); I.R.C. § 2624(a) (valuing GST at time of transfer); *but see* I.R.C. §§ 2032 and 2032A (permitting alternative valuation dates for estate tax); I.R.C. § 2624(b) and (c) (permitting alternative valuation dates for GST tax).

19. Undervaluation penalties are designed to corral figures within an acceptable range. See I.R.C. § 6662. Alternatively, taxpayers might have an incentive to overvalue assets. If the decedent’s gross estate is worth less than the I.R.C. § 2010(c) applicable exclusion amount, then the decedent’s estate has an incentive to inflate the value of property, up to the applicable exclusion amount, so that the heirs and beneficiaries will receive a higher I.R.C. § 1014 basis, thereby diminishing future gain or increasing future loss. Note that the I.R.C. § 2010(c) sunset provisions and I.R.C. § 1022 may alter these incentives.

20. Treas. Reg. §§ 20.2031-1(b) and 25.2512-1; *accord* United States v. Cartwright, 411 U.S. 546, 551 (1973); Estate of Cook v. Comm’r, 349 F.3d 850, 854 (5th Cir. 2003); Comm’r v. Stewart’s Estate, 153 F.2d 17, 18-19 (3d Cir. 1946); Snyder v. Comm’r, 93 T.C. 529, 539 (1989); Estate of Hall v. Comm’r, 92 T.C. 312, 335 (1989). The same test applies to GST valuation. ESTATE & GIFT, *supra* note 17.

21. See JOHN A. BOGDANSKI, FEDERAL TAX VALUATION ¶ 2.01[1], 2-3 to 2-5 (2003 Cum. Supp.) (noting that the willing buyer-willing seller test is nearly as old as the estate tax).

22. See *infra* notes 23-37 and accompanying text.

lowest price.²³ Neither is under compulsion, and both are free to buy and sell as they please.²⁴ Consequently, a forced liquidation or fire sale scenario is not an appropriate basis for valuation, as it is premised on a compulsion to sell that negates the willing exchange assumption.²⁵ To the contrary, the hypothetical transaction must be presumed to occur under prevailing market conditions in the ordinary course of business.²⁶

Second, the HWB and HWS are hypothetical market participants.²⁷ The value they place on property is independent from any emotions actual parties might possess.²⁸ The hypothetical parties have general characteristics, not the characteristics of actual buyers and sellers,²⁹ they are strangers with no familial connections.³⁰ Furthermore, the hypothetical parties are neither pessimists nor optimists.³¹ Most importantly, they are rational actors who seek to maximize their own economic advantage.³² Courts will assume that the hypothetical parties make rational decisions to advance their financial positions to the greatest extent possible; to this end, courts may not assume transactions that are contrary to the hypothetical parties' economic interests.³³

23. *Comm'r v. Stewart's Estate*, 153 F.2d 17, 18-19 (3d Cir. 1946); *Helvering v. Warbridge*, 70 F.2d 683, 684 (2d Cir. 1934).

24. VALUATION, *supra* note 21, ¶ 2.01[2][b][i], at 2-9 to 2-11.

25. *See id.*

26. *Estate of Curry v. United States*, 706 F.2d 1424, 1432-33 (7th Cir. 1983); *Estate of Newhouse v. Comm'r*, 94 T.C. 193, 218 (1990).

27. *See, e.g., Estate of Jelke v. Comm'r*, 507 F.3d 1317, 1321 n.11 (11th Cir. 2007), *rev'g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008); *Propstra v. United States*, 680 F.2d 1248, 1251-52 (9th Cir. 1981); *Estate of Newhouse*, 94 T.C. at 218; *Borgatello v. Comm'r*, 80 T.C.M. (CCH) 260, 264 (2000).

28. *See, e.g., Meaker Co. v. Comm'r*, 16 T.C. 1348, 1354-55 (1951); *Whittemore v. Fitzpatrick*, 127 F.Supp. 710, 715-16 (D. Conn 1954); *see also* VALUATION *supra* note 21, ¶ 2.01[2][c][ii], at 2-23 to 2-28; *but see Estate of Palmer v. Comm'r*, 839 F.2d 420, 423-24 (8th Cir. 1988), *rev'g*, 86 T.C. 66 (1986).

29. *See, e.g., Estate of Curry*, 706 F.2d at 1428, 1431; *Estate of Bright v. Comm'r*, 658 F.2d 999, 1005-06 (5th Cir. 1981); *Estate of Davis v. Comm'r*, 110 T.C. 530, 535 (1998); *Estate of Newhouse*, 94 T.C. at 218.

30. VALUATION, *supra* note 21, ¶¶ 2.01[2][c][iii], at 2-28 to 2-45, 4.03[4], at 4-63 to 4-90, 5.01[2][d], at 5-16 to 5-18.

31. *Compare Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, 1340 (2000) (noting actual shareholders' optimism concerning future returns), *rev'd on other grounds*, 301 F.3d 339 (5th Cir. 2002), *with id.* at 1345 (recognizing that HWB may have incentive to liquidate).

32. *See, e.g., Estate of Watts v. Comm'r*, 823 F.2d 483, 486 (11th Cir. 1987); *Estate of Curry*, 706 F.2d at 1428; *Propstra*, 680 F.2d at 1251-52; *Estate of Bright*, 658 F.2d at 1005-06; *Estate of Newhouse*, 94 T.C. at 218; *Estate of Simplot v. Comm'r*, 112 T.C. 130, 152 (1999), *rev'd on other grounds*, 249 F.3d 1191 (9th Cir. 2001); *Estate of Borgatello*, 80 T.C.M. (CCH) at 264.

33. *Estate of Curry*, 706 F.2d at 1428-29.

Third, the hypothetical parties have knowledge of all relevant facts.³⁴ This means that on the valuation date, they have knowledge of the relevant facts and circumstances existing at that time. The hypothetical parties are not clairvoyant, however, and future events may be considered only if they were reasonably foreseeable on the valuation date.³⁵ This third characteristic is related to the first two. For the hypothetical parties to transact in a willing manner commensurate with market bargaining, they must be equipped with the proper foundation for making informed decisions. Accordingly, they are deemed to have the most reliable and accurate information that a reasonable and intelligent investigation would reveal.³⁶ This knowledge also arises from a hypothetical vantage point. All relevant knowledge is imputed to the hypothetical parties, even if actual parties lack such information.³⁷

With these characteristics about the hypothetical parties in place, the next step is to determine the market from which the price will be derived. Where there is only one market with readily ascertainable prices, valuation can be straightforward.³⁸ Where multiple markets exist, the task becomes more challenging because valuation may rest on whether the hypothetical sale occurs in a wholesale or retail market.³⁹ Although market prices for many types of property are readily available, clear market prices do not exist for all property. Certain types of property are difficult to value because they lack a market in which they are commonly exchanged.

And so it is that calculating the built-in gain discount presents such a challenge⁴⁰—shares in closely-held corporations are a paradigm example of property for which no market exists.⁴¹ Where there is no market, an arm's length sale that has occurred near the time of valuation

34. See *Comm'r. v. Stewart's Estate*, 153 F.2d 17, 19 (3d Cir. 1946); *McShain v. Comm'r*, 71 T.C. 998, 1004 (1979) (citing *Bankers Trust Co. v. United States*, 207 Ct. Cl. 422 (1975)).

35. See *Estate of Simplot*, 112 T.C. at 152; *Estate of Newhouse*, 93 T.C. at 218; *Estate of Gilford v. Comm'r*, 88 T.C. 38, 52 (1987); *Messing v. Comm'r*, 48 T.C. 502, 509 (1967) (the successful public sale of stock two weeks after it was gifted did not decide the stock's value given the "vagaries of the stock market").

36. VALUATION, *supra* note 21, ¶ 2.01[3][a][i], at 2-47 to 2-49.

37. *Id.* ¶ 2.01[3][a][ii], at 2-53 to 2-54.

38. For example, valuation of publicly traded stocks and bonds is based on the mean of the highest and lowest quoted selling prices on the valuation date. Treas. Reg. §§ 20.2031-2(b)(1) and 25.2512-2(b)(1).

39. VALUATION, *supra* note 21, ¶ 2.01[4][b], at 2-81 to 2-97.

40. See *infra* text §§ III and IV.

41. See VALUATION, *supra* note 21, ¶ 2.01[5][c][i], at 2-104 to 2-109; ESTATE AND GIFT, *supra* note 17, ¶ 4.02[3][f], at 4-26 to 4-28.

can aid in calculating the value,⁴² but this is rarely the case. In the more likely scenario where no sale has recently occurred, regulations provide guidance.⁴³ If selling prices, bid prices, and ask prices are unavailable, the fair market value of stock may be determined by considering “the company’s net worth, prospective earning power and dividend-paying capacity, and other relevant factors.”⁴⁴ In *Revenue Ruling 59-60*,⁴⁵ the IRS also stressed the following factors:

- (a) The nature of the business and the history of the enterprise from its inception.
- (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
- (c) The book value of the stock and the financial condition of the business.
- (d) The earning capacity of the company.
- (e) The dividend-paying capacity.
- (f) Whether or not the enterprise has goodwill or other intangible value.
- (g) Sales of the stock and the size of the block of stock to be valued.
- (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.⁴⁶

Despite this guidance, none of the factors in the regulation or revenue ruling is controlling.⁴⁷ Courts have repeatedly stated that determining the factors’ relative weights depends upon the facts and

42. *Champion v. Comm’r*, 303 F.2d 887, 893 (5th Cir. 1962); *Estate of Davis v. Comm’r*, 110 T.C. 530, 536 (1998); *Ward v. Comm’r*, 87 T.C. 78, 101 (1986); *Estate of Andrews v. Comm’r*, 79 T.C. 938, 940 (1982), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm’r*, 155 F.3d 50, 54-55 (2d Cir. 1998); *Duncan Indus., Inc. v. Comm’r*, 73 T.C. 266, 276 (1979).

43. *See also* I.R.C. § 2031(b) (stating that valuation of unlisted stock and securities may be determined by comparison to other corporations engaged in the same or a similar line of business).

44. Treas. Reg. § 20.2031-2(f). Other relevant factors include:

[t]he good will of the business; the economic outlook in the particular industry; the company’s position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which [sic.] are listed on a stock exchange.

Id. (flush language).

45. Rev. Rul. 59-60, 1959-1 C.B. 237.

46. *Id.* at 238-39.

47. *Id.* at 238.

circumstances of each case.⁴⁸ Thus, the value of transferred property is a question of fact.⁴⁹ Nonetheless, proper valuation methodology is a question of law,⁵⁰ and courts rely on three approaches to value closely-held entities: the income approach, the market approach, and the net asset value approach.⁵¹

Under the income approach, an entity's value is determined by discounting to present value the stream of income it is expected to produce.⁵² The aggregate present value of future income determines the entity's value.⁵³ The entity's past earnings are used as the proxy for future earnings,⁵⁴ more recent earnings are considered a more accurate prediction of future income and are weighted accordingly.⁵⁵ The discounted income stream is typically calculated based upon future net income, which means the aggregated value is net of future corporate income taxes.⁵⁶ Because this approach looks to future income, it is applied to entities actively engaged in the production of income, usually through the sale of products or services.⁵⁷

48. See, e.g., *Estate of Jelke v. Comm'r*, 507 F.3d 1317, 1321 n.12 (11th Cir. 2007), *rev'g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008); *Eisenberg v. Comm'r*, 155 F.3d 50, 53 n.9 (2d Cir. 1998); *Estate of Goodall v. Comm'r*, 391 F.2d 775, 786 (8th Cir. 1968); *Estate of Davis v. Comm'r*, 110 T.C. 530, 536-37 (1998); *Litton Bus. Sys., Inc. v. Comm'r*, 61 T.C. 367, 376 (1973); *Roschuni v. Comm'r*, 29 T.C. 1193, 1201-02 (1958), *aff'd*, 271 F.2d 267 (5th Cir. 1959); *Estate of Gray v. Comm'r*, 73 T.C.M. (CCH) 1940, 1945 (1997).

49. See, e.g., *Hamm v. Comm'r*, 325 F.2d 934, 938 (8th Cir. 1963); *Estate of Jung v. Comm'r*, 101 T.C. 412, 423-24 (1993); *Estate of Newhouse v. Comm'r*, 94 T.C. 193, 217 (1990); *Estate of Jephson v. Comm'r*, 87 T.C. 297, 303 (1986); *Estate of Andrews v. Comm'r*, 79 T.C. 938, 940 (1982), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998); *Estate of Deputy v. Comm'r*, 85 T.C.M. (CCH) 1497, 1500 (2003).

50. See, e.g., *Powers v. Comm'r*, 312 U.S. 259, 260 (1941); *Estate of Jelke*, 507 F.3d at 1321; *Estate of Dunn v. Comm'r*, 301 F.3d 339, 348 (5th Cir. 2002); *Adams v. United States*, 218 F.3d 383, 386 (5th Cir. 2000); *In re T.H. New Orleans, Ltd. P'ship*, 116 F.3d 790, 799 (5th Cir. 1997).

51. ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b], at 4-15 to 4-17; see also *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) 1397, 1402 (2005), *rev'd on other grounds*, 507 F.3d 1317 (11th Cir. 2007); *Estate of Kelley v. Comm'r*, 90 T.C.M. (CCH) 369, 371 (2005); *Estate of Borgatello v. Comm'r*, 80 T.C.M. (CCH) 260, 266 (2000).

52. VALUATION, *supra* note 21, ¶ 3.05[1][a], at 3-49 to 3-51; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][i], at 4-16; *Estate of Jelke*, 89 T.C.M. (CCH) at 1402; *Estate of Kelley*, 90 T.C.M. (CCH) at 371.

53. VALUATION, *supra* note 21, ¶ 3.05[1][a], 3-49 to 3-51; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][i], at 4-16.

54. VALUATION, *supra* note 21, ¶ 3.05[4][d], at 3-64 to 3-69; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][i], at 4-16.

55. VALUATION, *supra* note 21, ¶ 3.05[4][d][iv], at 3-68 to 3-69; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][i], at 4-16.

56. VALUATION, *supra* note 21, ¶¶ 3.05[4][a], at 3-61 to 3-62 and 6.03[6][b], at 6-48 to 6-50.

57. *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507, 1511 (1993), *aff'd*, 53 F.3d 924 (8th Cir. 1995).

The market approach determines an entity's value by comparing the entity to similar entities with more readily ascertainable values.⁵⁸ In essence, valuation is determined by relying on the value of comparable entities.⁵⁹ Comparison with publicly traded entities is preferred, as the value of such entities can be determined from prevailing market prices.⁶⁰ However, comparable sales may also be derived from the private market.⁶¹ Once the comparable sales price is determined, it must be adjusted to reflect differences between the comparable entity and the entity being valued.⁶² The market approach can be of limited use, as it is appropriate only where comparable entities are similar enough to the entity being valued. Where variations between the comparable entity and the entity being valued are too great to be remedied by adjustment, this method is typically avoided.⁶³

Finally, under the net asset value approach, an entity's value is determined by subtracting its liabilities from the fair market value of its underlying assets.⁶⁴ Thus, the aggregate net asset value of an entity's assets determines the entity's value. The net asset value approach is applied to entities without an active business, such as holding entities or entities engaged in investment activities.⁶⁵ These entities typically produce relatively little income compared to the fair market value of the underlying assets, making these entities particularly amenable to this

58. VALUATION, *supra* note 21, ¶ 3.04[1], at 3-23 to 3-27; ESTATE & GIFT, *supra* note 17, at ¶ 4.02[2][b][ii], at 4-16; Estate of Jelke v. Comm'r, 89 T.C.M. (CCH) 1397, 1402 (2005), *rev'd on other grounds*, 507 F.3d 1317 (11th Cir. 2007); Estate of Kelley v. Comm'r, 90 T.C.M. (CCH) 369, 371 (2005).

59. VALUATION, *supra* note 21, ¶ 3.04[1], at 3-23 to 3-27.

60. *Id.*; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][ii], at 4-16.

61. See VALUATION, *supra* note 21, ¶ 3.04[3][c], at 3-39 to 3-43.

62. VALUATION, *supra* note 21, ¶ 3.04[2][c], at 3-30 to 3-35; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][ii], at 4-16.

63. VALUATION, *supra* note 21, ¶ 3.04[3][c], at 3-39 to 3-43.

64. VALUATION, *supra* note 20, ¶ 3.04[1], at 3-23 to 3-27; ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][iii], at 4-17; Eisenberg v. Comm'r, 155 F.3d 50, 52 n.6 (2d Cir. 1998) (citing *Andrews v. Comm'r*, 35 T.C.M. (CCH) 459, 463 (1976)); Estate of Kelley v. Comm'r, 90 T.C.M. (CCH) 369, 371 (2005); Estate of Jelke v. Comm'r, 89 T.C.M. (CCH) 1397, 1402 (2005); *Estate of Andrews*, 35 T.C.M. (CCH) at 463. This approach is similar to a cost method of valuation, under which the value of the entity is determined by calculating the cost of acquiring its underlying assets. See VALUATION, *supra* note 21, ¶ 3.06, at 3-79 to 3-96.

65. ESTATE & GIFT, *supra* note 17, ¶ 4.02[2][b][iii], at 4-17; Estate of Piper v. Comm'r, 72 T.C. 1062, 1071-72 (1979), *superseded by statute on other grounds*, Tax Reform Act of 1986, Pub. L. No. 99-514 § 631, 100 Stat. 2085, *as recognized in* Eisenberg v. Comm'r, 155 F.3d 50, 54-55 (2d Cir. 1998); Estate of Borgatello v. Comm'r, 80 T.C.M. (CCH) 260, 266 (2000); Estate of Ford v. Comm'r, 66 T.C.M. (CCH) 1507, 1511 (1993), *aff'd*, 53 F.3d 924 (8th Cir. 1995); Estate of Jephson v. Comm'r, 87 T.C. 297, 303-04 (1986).

type of valuation.⁶⁶ Moreover, even where minimal business activity is involved, the net asset value approach may still be appropriate and preferred.⁶⁷ An important assumption about the net asset value approach is that the HWB purchases the entity to obtain ownership of the entity's underlying assets.⁶⁸ This assumption holds true because the value of the entity is not determined from the entity's income producing capacity; instead, the entity's assets provide the value.⁶⁹ However, this assumption does not imply that the HWB purchases the entity with the objective of immediately converting the assets into cash.⁷⁰

Not all entities are amenable to valuation by just one approach. Some entities will have both operating and investment components; comparable sales might reflect some components of an entity yet be inapposite to others.⁷¹ In such cases, courts permit a combination of the approaches to value the entity's respective components.⁷² Under this hybrid approach, courts will rely on expert testimony to value the components.⁷³ If the components can be easily segregated, the components can be independently valued; where the components are intertwined, expert testimony will determine the weight to be placed on the respective components.⁷⁴

66. *Estate of Borgatello*, 80 T.C.M. (CCH) at 266; See also *ESTATE & GIFT*, *supra* note 17, ¶ 4.02[2][b][iii], at 4-17.

67. See *Estate of Lee v. Comm'r*, 69 T.C. 860, 869-70 (1978); *Estate of Ford*, 66 T.C.M. (CCH) at 1517.

68. See *Estate of Dunn v. Comm'r*, 301 F.3d 339, 353 (5th Cir. 2002); *Estate of Cruikshank v. Comm'r*, 9 T.C. 162, 165 (1947), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514 § 631, 100 Stat. 2085, *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

69. *Estate of Borgatello*, 80 T.C.M. (CCH) at 266; See *Ward v. Comm'r*, 87 T.C. 78, 102 (1986), *superseded by statute on other grounds*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

70. *Ward*, 87 T.C. at 104; *Estate of Cruikshank*, 9 T.C. at 165. As discussed *infra* note 313 and accompanying text, this is an essential point as it relates to determining the built-in gain discount. Simply stated, the HWB has the choice of either holding the underlying assets or converting the assets to cash. The HWB should be presumed to take the more economically beneficial course of action, which may or may not be conversion to cash.

71. See *Estate of Dunn v. Comm'r*, 301 F.3d at 350.

72. *ESTATE & GIFT*, *supra* note 17, ¶ 4.02[2][b][iv], at 4-17; See *Estate of Andrews v. Comm'r*, 79 T.C. 938, 944 (1982), *superseded by statute on other grounds*, Tax Reform Act § 631, *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998); *Estate of Ford*, 66 T.C.M. (CCH) at 1520; *Estate of Gallun v. Comm'r*, 33 T.C.M. (CCH) 1316, 1320 (1974), *superseded by statute on other grounds*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998); *Estate of Thalheimer v. Comm'r*, 33 T.C.M. (CCH) 877, 908-11 (1974).

73. See *Estate of Ford*, 66 T.C.M. at 1520-22; *Estate of Thalheimer*, 33 T.C.M. at 911.

74. See *Estate of Ford*, 66 T.C.M. at 1522; *Estate of Thalheimer*, 33 T.C.M. at 911.

Once the undiscounted fair market value of the transferred property is determined, courts consider whether any valuation discounts are appropriate.⁷⁵ The discounts that are most frequently applied to closely-held entities are for a lack of control and for a lack of marketability. The lack of control discount is available where the valued interest entails insufficient voting control to effectuate liquidation or to dictate the entity's courses of action.⁷⁶ Thus, a lack of control discount is typically applied to nonvoting or minority interests.⁷⁷ The lack of marketability discount is applied in circumstances where there is a limited market in which the asset can be sold or where there are restrictions on transferring the interest.⁷⁸ Several considerations that may factor into the computation of the lack of marketability discount include any applicable securities regulations,⁷⁹ a lack of public awareness concerning the valued asset,⁸⁰ and risk associated with the investment.⁸¹ As discussed below, the built-in gain discount should be applied as a subsidiary component in the lack of marketability discount.⁸²

These basic valuation principles form the foundation for decisions addressing the built-in gain discount. At issue in these cases is valuation under the net asset value approach of closely-held C corporations, where the fair market value of a corporation's underlying assets exceeds its basis in the assets. The question then becomes how a HWB valuing a corporation under the net asset value approach would account for the built-in gain. Although this determination is shaped by the imputed characteristics of the HWB, it is also inextricably tied to the treatment subchapter C dictates for corporate distributions and liquidations.

75. See, e.g., *Estate of Gallun*, 33 T.C.M. at 1320; *Estate of Thalheimer*, 33 T.C.M. at 911.

76. See *ESTATE & GIFT*, *supra* note 17, ¶ 4.02[4][c][i], at 4-38.

77. See *VALUATION*, *supra* note 21, ¶ 4.03[1][a], at 4-26 to 4-28.

78. See *ESTATE & GIFT*, *supra* note 17, at ¶ 4.02[4][d][i], at 4-40.

79. JOHN A. BOGDANSKI, *FEDERAL TAX VALUATION* ¶ 4.04[1][a][i] (2008 Supp.). Under federal and state law, unregistered securities, such as interests in closely-held entities, can be sold only in limited markets. *Id.*

80. *Id.* at ¶ 4.04[1][a][ii]. Where the public lacks knowledge of the availability of the valued asset, there will be fewer interested buyers and a correspondingly lower demand.

81. *Id.* at ¶ 4.04[1][a][iii].

82. See *infra* text § IV.C.

III. DEVELOPMENT OF THE BUILT-IN GAIN DISCOUNT

A. Built-in Gain Discounts under the General Utilities Doctrine

When litigation first began on the issue of the built-in gain discount, C corporations reaped the benefits of an era governed by the *General Utilities* doctrine. Stated generally, the *General Utilities* doctrine provided corporations nonrecognition of gain or loss on distributions of corporate property to shareholders with respect to their stock.⁸³ The doctrine came from the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*.⁸⁴ The General Utilities and Operating Company ("General Utilities") received an offer for the purchase of its shares in the Islands Edison Company.⁸⁵ Rather than selling the shares directly, General Utilities distributed the Islands Edison stock as a dividend to its shareholders,⁸⁶ and the shareholders subsequently sold their shares to the offering buyer.⁸⁷ The Court held that because the distribution did not constitute a sale and the shares were not used to discharge indebtedness,⁸⁸ General Utilities recognized no gain on the transaction.⁸⁹ Although judicial decisions and statutory amendments would eventually erode the *General Utilities* doctrine,⁹⁰ the

83. See BORIS BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶ 8.20[3], 8-72 to 8-73 (7th ed. Supp. 2008); Louis F. Lobenhofer, *The Repeal of General Utilities [Operating Co. v. Helvering, 296 U.S. 200] for Corporate Liquidations: The Consequences of Incomplete and Unexpected Tax Reform*, 4 AKRON TAX J. 153, 153 (1987); Eric S. Shube, *Corporate Income or Loss on Distributions of Property: An Analysis of General Utilities*, 12 J. CORP. TAX'N 3 (1985). The shareholders would take a fair market value basis in the property received, thereby eliminating the built-in gain. See Lobenhofer, *supra*, at 153-54.

84. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085 (1986), *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998). The doctrine arguably predated the decision in *General Utilities*. See BITTKER & EUSTICE, *supra* note 83, ¶ 8.20[2], at 8-70 to 8-71; Shube, *supra* note 83, at 9; *First Sav. Bank of Ogden v. Burnet*, 53 F.2d 919, 921 (D.C. Cir. 1931).

85. *Gen. Utils.*, 296 U.S. at 201-02.

86. *Id.* at 202-03.

87. *Id.* at 203.

88. There was some debate as to whether *General Utilities* had declared a cash dividend. Where a dividend was declared that could be satisfied only in cash, then a distribution in kind was treated as a payment in relief of indebtedness. Such a transaction would have required gain recognition. See *id.* at 204; Shube, *supra* note 83, at 11-13.

89. *Gen. Utils.*, 296 U.S. at 206.

90. See BITTKER & EUSTICE, *supra* note 83, ¶ 8.20[3], 8-72 to 8-73; Lobenhofer, *supra* note 83, at 155-59; Shube, *supra* note 83, at 27-37 (summarizing statutory limitations on the *General Utilities* rule).

doctrine won Congressional approval in the 1954 Code.⁹¹ The nonrecognition principle was incorporated into subchapter C, with former § 311 (1954) governing nonliquidating distributions and former §§ 336 and 337 (1954) governing liquidating distributions.⁹²

While the *General Utilities* doctrine was alive and well, the nonrecognition afforded to liquidating and nonliquidating distributions shaped the transfer tax treatment of built-in gains in closely-held C corporations. Beginning with *Estate of Cruikshank v. Commissioner*,⁹³ the Tax Court consistently disallowed a built-in gain discount.⁹⁴ In *Estate of Cruikshank*, the Tax Court considered the estate tax valuation of the decedent's shares in Cruikshank Investment Co., a closely-held C corporation that served as a holding company for cash, stocks, bonds, and real estate.⁹⁵ These underlying assets had appreciated since their purchase, resulting in built-in gain.⁹⁶ The court considered the propriety of discounting the decedent's shares to reflect the potential tax liability that would be incurred upon the sale of the underlying assets.⁹⁷ Without further reasoning, the court determined no discount should be allowed for "hypothetical and suppositious liability for taxes on sales not made nor projected."⁹⁸

After the 1954 integration of the *General Utilities* doctrine into the Code, the Tax Court continued to follow *Estate of Cruikshank* and more clearly articulated the standard for determining the availability of the discount. What developed was a prospective liquidation test. First, courts considered whether at the time of the transfer the corporation had

91. Lobenhofer, *supra* note 83, at 158; Shube, *supra* note 83, at 3.

92. See Internal Revenue Act of 1954, Pub. L. No. 83-591, §§ 311, 336-37, 68A Stat. 3.

93. *Estate of Cruikshank v. Comm'r*, 9 T.C. 162 (1947), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085 (1986), *as recognized in* Eisenberg v. Comm'r, 155 F.3d 50, 54-55 (2d Cir. 1998). *Cruikshank* is often cited as the first major case on the issue. *But see also* Richardson v. Comm'r, 151 F.2d 102 (2d Cir. 1945); *Estate of Huntington v. Comm'r*, 36 B.T.A. 698 (1937).

94. It is interesting to note that prior to the repeal of the *General Utilities* doctrine, federal district courts decided the only two cases allowing the built-in gain discount. See *Clark v. United States*, 36 A.F.T.R.2d 75-6417, 75-6419-20 (E.D.N.C. 1975) (holding, without citation to authority, that sale of closely-held company's underlying investment portfolio would result in capital gains tax, and that a willing buyer would take such tax into account in valuing the company's shares); *Obermer v. United States*, 238 F.Supp. 29, 35-36 (D. Haw. 1964) (allowing some discount for built-in gains on account of strong and convincing expert testimony not proffered in *Cruikshank*). The Tax Court, however, consistently denied the discount. See *infra* notes 101-122 and accompanying text.

95. *Estate of Cruikshank*, 9 T.C. at 162-63.

96. *Id.* at 164.

97. *Id.* at 165.

98. *Id.*

plans to liquidate the underlying assets.⁹⁹ Second, courts determined whether a future liquidation of the corporation could be performed without triggering tax on the built-in gains.¹⁰⁰

Thus, in *Gallun v. Commissioner*,¹⁰¹ the Tax Court denied a built-in gain discount in valuing the donor's shares in his closely-held company.¹⁰² The company functioned as both an operating company and as a holding company.¹⁰³ In valuing the entity, the court segregated the operating assets from the investment portfolio and valued the investment portfolio under the net asset value approach.¹⁰⁴ Because the corporation had no immediate plans to liquidate the portfolio and because corporate liquidation could be achieved without incurring tax, the court denied the discount for potential capital gains tax.¹⁰⁵

Although *Gallun* was decided earlier, the decision in *Estate of Piper v. Commissioner*¹⁰⁶ was the foundation of the prospective liquidation test.¹⁰⁷ In *Estate of Piper*, the donor, deceased at the time of the case, transferred all the issued and outstanding stock in two

99. See, e.g., *Estate of Andrews v. Comm'r*, 79 T.C. 938, 942 (1982), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998); *Estate of Piper v. Comm'r*, 72 T.C. 1062, 1087 (1979), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

100. See, e.g., *Estate of Piper*, 72 T.C. at 1087. *But see* *Estate of Thalheimer v. Comm'r*, 33 T.C.M. (CCH) 877, 911 (1974) (considering only whether at the time of the transfer there was a plan of liquidation). The distinction between the first consideration and second consideration is sometimes confused in the case law. The first consideration looks to whether "liquidation" of the assets is contemplated, meaning whether the corporation is planning to sell the underlying assets. The second consideration looks to the consequences of a corporate "liquidation," meaning the winding up of the company or the distribution of the assets to the shareholders. Under the *General Utilities* doctrine, the second consideration led courts to conclude that gain could be avoided. Therefore, unless the corporation were planning an asset sale, the discount was denied. The distinction between an asset sale and a corporate liquidation is considered further *infra* text § IV.B.

101. *Gallun v. Comm'r*, 33 T.C.M. 1316 (1974), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

102. *Id.* at 1321.

103. *Id.* at 1317.

104. *Id.* at 1320.

105. *Id.* at 1321.

106. *Estate of Piper v. Comm'r*, 72 T.C. 1062 (1979), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

107. To date, *Estate of Piper* has been cited in forty-nine decisions, whereas *Gallun* has been cited in nineteen. As a Tax Court opinion, *Estate of Piper* carries more precedential weight than *Gallun*, a Tax Court Memorandum opinion.

investment corporations.¹⁰⁸ Under the net asset value approach, part of the reduction from fair market value that the donor claimed was attributable to potential capital gains tax the corporation would incur upon the sale of its assets.¹⁰⁹ Citing *Estate of Cruikshank*, Judge Tannenwald relied on a prospective liquidation test, using the prospect and effect of liquidation as the criteria for determining the availability of the discount.¹¹⁰ Because there was no evidence of a pending liquidation or that a liquidation would trigger gain recognition,¹¹¹ the court denied the discount.¹¹²

Judge Tannenwald's test took root, and in *Estate of Andrews v. Commissioner*,¹¹³ the Tax Court based its opinion on the same inquiry. In *Estate of Andrews*, the decedent's gross estate included stock in four closely-held corporations.¹¹⁴ The decedent owned about twenty percent of each corporation, and the remaining eighty percent was split evenly among his four siblings.¹¹⁵ All four corporations primarily owned and managed commercial real estate; some also held stocks and bonds.¹¹⁶ In valuing the corporations' holding components, the estate calculated the net asset value of the decedent's shares.¹¹⁷ The estate argued for a built-in gain discount.¹¹⁸ However, no liquidation was imminent,¹¹⁹ nor was there any evidence that liquidation could not be executed without gain recognition. The court held that mere speculation as to liquidation does not merit valuation discounts where it is unlikely that the contemplated

108. *Estate of Piper*, 72 T.C. at 1064. Both investment companies held corporate stock of an operating company, Piper Aircraft Co. *Id.* Civil procedure aficionados will note that this is the same Piper Aircraft Co. that would later star in the famed *forum non conveniens* case. See *Piper Aircraft Co. v. Reyno*, 454 U.S. 235 (1981).

109. *Estate of Piper*, 72 T.C. at 1086-87.

110. *Id.* In so doing, Judge Tannenwald expressly rejected the previous holding of *Obermer v. United States*. 238 F.Supp. 29 (D. Haw. 1964). *Accord supra* note 94.

111. Although the opinion did not expressly state the principle, corporate liquidation could have been accomplished tax-free under *General Utilities* and former I.R.C. §§ 311 and 336 (West 1954). The fact that corporate liquidation would not cause gain recognition made the allowance of the discount unnecessary.

112. *Estate of Piper*, 72 T.C. at 1087.

113. *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085 (1986), *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998).

114. *Id.* at 938.

115. *Id.* at 938-39.

116. *Id.* at 939.

117. *Id.* at 942-43.

118. *Id.* at 942.

119. *Estate of Andrews v. Comm'r*, 79 T.C. 938, 942 (1982), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085 (1986), *as recognized in Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998).

liquidation expenses, including tax liability, will ever become due.¹²⁰ The court denied the discount.¹²¹

B. Repeal of General Utilities and the Rise of the Built-in Gain Discount

While the Tax Court continued to deny the built-in gain discount,¹²² unrest regarding the *General Utilities* doctrine arose in the corporate tax world. Exceptions were carved out from the nonrecognition principle almost from its inception,¹²³ and concern grew that the *General Utilities* doctrine was eroding the corporate tax base by subverting the subchapter C principle of two-tiered taxation.¹²⁴ A major critique leading to the doctrine's demise came in 1977 from the American Law Institute,¹²⁵ and in 1983 the Senate Finance Committee echoed the criticism.¹²⁶ To the extent the *General Utilities* doctrine remained intact,¹²⁷ Congress responded with statutory changes.¹²⁸ By 1986, full repeal of the *General Utilities* doctrine had been accomplished, with § 311(b) swallowing the nonrecognition of gain provided in § 311(a), and § 336 requiring gain and loss recognition on distributions made in complete liquidation.¹²⁹

As they related to transfer taxation, these changes in the corporate tax system would eventually erode the precedential value of *Estate of Cruikshank* and the prospective liquidation test. Nonetheless, it took some time for the splash made by the *General Utilities* repeal to ripple into the transfer tax world. The initial lag in the Tax Court's recognition of the transfer tax consequences of the *General Utilities* repeal resulted

120. *Id.*

121. *Id.*

122. *Ward v. Comm'r*, 87 T.C. 78, 103-04 (1986) (denying built-in gain discount for gifts of corporate stock that donor made from 1979 to 1981), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998); *Estate of Bennett v. Comm'r*, 65 T.C.M. (CCH) 1816, 1825 (1993) (denying built-in gain discount for bequest made upon decedent's death in 1985).

123. *See supra* note 90.

124. *See* Walter J. Blum, *Taxing Transfers of Incorporated Businesses: A Proposal for Improvement*, 52 TAXES 516, 523 (1974); Shube, *supra* note 83, at 41-42.

125. Lobenhofer, *supra* note 83, at 154.

126. *Id.* *See also* George K. Yin, *General Utilities Repeal: Is Tax Reform Really Going to Pass It By?*, 31 TAX NOTES 1111, 1112 (1986).

127. *See supra* note 90.

128. *See* Lobenhofer, *supra* note 83, at 158-59; Shube, *supra* note 83, at 30-41.

129. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085. Since 1986, only minor changes have been made to I.R.C. §§ 311 and 336. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1006(e)(8)(B), 1006(e)(21)(A), 1006(e)(21)(B), and 1018(d)(5)(E), 102 Stat. 3342, 3401, 3403, 3580. Under current law, corporations are generally required to recognize gain on the distribution of appreciated assets. *But see* I.R.C. § 337 (providing nonrecognition for property distributed to parent in complete liquidation of subsidiary).

from the Tax Court's failure to consider the way in which the new subchapter C provisions would yield a different outcome under the prospective liquidation test. Perhaps a cursory application of the test resulted as denial of the built-in gain discount had become standard practice. Indeed, decisions tended to overlook the second consideration of the prospective liquidation test¹³⁰—whether a future liquidation of the corporation could be performed without incurring tax liability.¹³¹

Thus, in *Estate of Ford v. Commissioner*,¹³² the Tax Court denied a built-in gain discount in valuing the investment division of the decedent's closely-held corporation.¹³³ As the transfers occurred in 1988 upon the decedent's death, the decision should have discussed the impact of the 1986 *General Utilities* repeal. Yet the Tax Court examined only whether the corporation was considering a plan of liquidation,¹³⁴ not whether liquidation could be performed without incurring tax. Had it taken this second step, as prior courts had done, the Tax Court might have recognized that the new subchapter C provisions would prohibit tax-free liquidation.

Soon after *Estate of Ford*, however, the Tax Court did realize that the repeal of the *General Utilities* doctrine would impact the built-in gain discount, though its opinions resulted only in dicta. In *Estate of Luton v. Commissioner*,¹³⁵ the Tax Court emphasized the second consideration of the prospective liquidation test.¹³⁶ However, because the corporations in question were S corporations, a prospective liquidation could still be performed without gain recognition,¹³⁷ and the court denied the built-in gain discount.¹³⁸

The Tax Court also acknowledged the significance of the subchapter C amendments but declined to apply the new law to the facts

130. This was likely due to the fact that courts often considered the built-in gain discount with other costs that would be incurred upon liquidation. See *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507, 1517 (1993), *aff'd*, 53 F.3d 924 (8th Cir. 1995); *Ward v. Comm'r*, 87 T.C. 78, 104 (1986), *superseded by statute*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, *as recognized in* *Eisenberg v. Comm'r*, 155 F.3d 50, 54-55 (2d Cir. 1998); *Estate of Thalheimer v. Comm'r*, 33 T.C.M. (CCH) 877, 911 (1974); See also I.R.S. Tech. Adv. Memo. 9150001 (Dec. 31, 1991).

131. See *supra* note 100.

132. *Estate of Ford*, 66 T.C.M. (CCH) at 1507.

133. *Id.* at 1517.

134. *Id.*

135. *Estate of Luton v. Comm'r*, 68 T.C.M. (CCH) 1044 (1994).

136. *Id.* at 1050.

137. *Id.*

138. *Id.*

of *Estate of Gray v. Commissioner*.¹³⁹ In *Estate of Gray*, two irrevocable trusts, which the decedent had settled inter vivos, purchased real property from the decedent's closely-held C corporation.¹⁴⁰ The trusts issued a promissory note as consideration,¹⁴¹ and the corporation elected to report its gain on the installment method.¹⁴² Because the trusts were too highly leveraged, they were unable to repay the note unless they resold the property.¹⁴³ Market conditions proved unfavorable, and at the time of the Tax Court's decision, payment of the note was seven years past-due.¹⁴⁴ This fact, coupled with the fact that the corporation could exercise a tax-free foreclosure,¹⁴⁵ led the court to determine that recognition of the built-in gain was unlikely.¹⁴⁶ Still, the taxpayer argued that the repeal of the *General Utilities* doctrine required a built-in gain discount.¹⁴⁷ Although the Tax Court emphasized the importance of the change in the corporate tax law, it held that the *General Utilities* doctrine had no relevance to installment obligations.¹⁴⁸

Finally, in 1998, the Tax Court and the Court of Appeals for the Second Circuit recognized the transfer tax consequences of the *General Utilities* repeal.¹⁴⁹ Both courts issued opinions that reshaped the transfer tax treatment of built-in gains. The Second Circuit opinion in *Eisenberg v. Commissioner*¹⁵⁰ came on appeal from the Tax Court, where the previous year Judge Hamblen issued his memorandum decision denying a built-in gain discount.¹⁵¹ The Second Circuit heard oral arguments in May of 1998.¹⁵² In June of 1998, Judge Chiechi wrote the Tax Court's opinion rejecting Judge Hamblen's *Eisenberg* ruling, and she announced in *Estate of Davis v. Commissioner*¹⁵³ that a built-in gain discount would now be permitted.¹⁵⁴ The Second Circuit thus received a green light

139. *Estate of Gray v. Comm'r*, 73 T.C.M. (CCH) 1940 (1997).

140. *Id.* at 1944.

141. Also at issue in the case was whether the note was bona fide debt. *Id.* at 1946. The court held that the note was not bona fide. *Id.*

142. *Id.* at 1944.

143. *Id.*

144. *Estate of Gray v. Comm'r*, 73 T.C.M. (CCH) 1940, 1944 (1997).

145. See I.R.C. § 1038 (providing nonrecognition treatment for real property foreclosures).

146. *Estate of Gray*, 73 T.C.M. (CCH) at 1947.

147. *Id.*

148. *Id.* Instead, the disposition of the note would have been governed by I.R.C. § 453B.

149. *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998); *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998).

150. *Eisenberg*, 155 F.3d at 50.

151. *Eisenberg v. Comm'r*, 74 T.C.M. (CCH) 1046 (1997), *rev'd*, 155 F.3d 50 (2d Cir. 1998).

152. *Eisenberg*, 155 F.3d at 50.

153. *Estate of Davis*, 110 T.C. at 530.

154. *Id.* at 553.

from the Tax Court and in August of 1998 cited *Estate of Davis* with approval.¹⁵⁵ It did expressly what the Tax Court had already done implicitly¹⁵⁶—overrule Judge Hamblen’s opinion in *Eisenberg*.¹⁵⁷

Estate of Davis thus represented a shift in the Tax Court since the *Eisenberg* decision,¹⁵⁸ where the opinion placed significant weight on the long line of cases denying the built-in gain discount.¹⁵⁹ *Eisenberg* involved a transfer of stock in the donor’s closely-held corporation, which owned commercial real property.¹⁶⁰ Although the donor argued that the *General Utilities* repeal required a corresponding change in the transfer tax treatment of built-in gains, Judge Hamblen disagreed.¹⁶¹ He accepted the IRS’s argument regarding hypothetical scenarios under which a corporation might postpone corporate level gain either by indefinitely holding the property or by transferring the property pursuant to a nonrecognition provision.¹⁶²

The facts in *Estate of Davis*¹⁶³ were similar. The taxpayer, deceased at the time of the opinion, made inter vivos gifts of shares in his closely-held corporation, the primary asset of which was Winn-Dixie stock.¹⁶⁴ The IRS issued a notice of deficiency asserting undervaluation.¹⁶⁵ The valuation dispute was due in part to the taxpayer’s claim of a built-in gain discount. In an interesting twist, the IRS faced the challenge of arguing against its own expert, who testified a built-in gain discount should be allowed, just not to the extent the taxpayer claimed.¹⁶⁶ Nonetheless, relying on *Estate of Cruikshank* and

155. *Eisenberg*, 155 F.3d at 50.

156. The Tax Court in *Estate of Davis* made an unconvincing attempt to distinguish *Estate of Davis* from *Eisenberg* on the basis of the proffered expert testimony. See *Estate of Davis*, 110 T.C. at 552 n.17.

157. The case of *Estate of Welch v. Comm’r*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. 2000) (unpublished table decision), also holds an interesting place on this timeline. Without mentioning the *General Utilities* doctrine or its subsequent repeal, the Tax Court denied the built-in gain discount for 1993 bequests of stock in two closely-held corporations. *Estate of Welch v. Comm’r*, 75 T.C.M. (CCH) 2252, 2255-56 (1998). The May 1998 opinion in *Estate of Welch* relied on the Tax Court’s *Eisenberg* decision from the previous October. *Id.* at 2256. Less than two months after *Estate of Welch*, the Tax Court decided *Estate of Davis*. 110 T.C. 530 (1998). The decision on appeal in *Estate of Welch* came in March of 2000 and reversed the Tax Court. *Estate of Welch*, 2000 U.S. App. LEXIS 3315.

158. *Eisenberg v. Comm’r*, 74 T.C.M. (CCH) 1046 (1997).

159. See *Eisenberg*, 74 T.C.M. at 1048.

160. *Eisenberg*, 155 F.3d at 51-52.

161. *Eisenberg*, 74 T.C.M. (CCH) at 1049.

162. *Id.* The Tax Court cited I.R.C. §§ 351 and 355 as relevant nonrecognition provisions. *Id.*

163. *Estate of Davis v. Comm’r*, 110 T.C. 530 (1998).

164. *Id.* at 531.

165. See *id.* at 534.

166. *Id.* at 545-46.

its progeny, the IRS asserted that as a matter of law a built-in gain discount was impermissible.¹⁶⁷ The Tax Court turned to the two considerations of the prospective liquidation test¹⁶⁸ and found that even if no liquidation were contemplated, the discount would be appropriate if corporate level tax could not be avoided.¹⁶⁹ The court recognized the implications of the *General Utilities* repeal, but it stressed that repeal alone would not require eventual corporate level recognition in all circumstances.¹⁷⁰

Specifically, the 1986 amendments did not eliminate the possibility that a C corporation could make a § 1362(a) election to be treated as a subchapter S corporation.¹⁷¹ If a corporation were to make the election and then hold the assets for ten years, corporate level gain could be avoided.¹⁷² The IRS argued that this technique required denial of the built-in gain discount and that the *General Utilities* repeal was irrelevant.¹⁷³ As a factual conclusion, however, the Tax Court found that the corporation in *Estate of Davis* was unlikely to make a § 1362(a) election.¹⁷⁴ First, the election would unreasonably restrict the permissible shareholders.¹⁷⁵ Second, the ten-year waiting period would reduce the company's stock value, rendering it unmarketable; therefore, the corporation's shareholders would have been unlikely to consent to the election.¹⁷⁶ Accordingly, the Tax Court found that an HWB and HWS would have taken into account the potential tax liability when valuing the stock.¹⁷⁷

167. *Id.* at 546-47 (citing *Estate of Cruikshank v. Comm'r*, 9 T.C. 162, 165 (1947)).

168. *Id.* at 546-48.

169. *Estate of Davis v. Comm'r*, 110 T.C. 530, 550 (1998).

170. *Id.* at 546 (stating that "[t]he repeal . . . did not foreclose the possibility of avoiding capital gains taxes at the corporate level upon sale of all assets.").

171. *Id.* at 548-49.

172. *Id.* at 548; see I.R.C. § 1374(a) and (d)(7).

173. *Estate of Davis*, 110 T.C. at 545-46.

174. *Id.* at 549.

175. *Id.* at 548. Under I.R.C. § 1361(b)(1)(A), a corporation may be an S corporation only if it has no more shareholders than the statutory maximum. In 1992, the maximum number of shareholders permitted was 35. See I.R.C. § 1361(b)(1)(A). Furthermore, certain persons, such as C corporations, are prohibited from being shareholders in S corporations. See I.R.C. § 1361(b)(1)(B).

176. *Estate of Davis*, 110 T.C. at 548. Moreover, even if the company were to make an I.R.C. § 1362(a) election, any sale of corporate assets within the ten-year waiting period would continue to be subject to corporate level tax. If such a sale is likely to take place, some built-in gain discount may still be appropriate. See *Estate of Litchfield v. Comm'r*, 97 T.C.M. (CCH) 1079 (2009) (permitting built-in gain discount for S corporation in which sales of corporate assets were likely to occur within ten-years of the I.R.C. § 1362(a) election).

177. *Estate of Davis*, 110 T.C. at 552.

Yet this conclusion did not resolve the case. Having determined that it would allow a built-in gain discount, the court confronted the question of how large a discount to permit.¹⁷⁸ The court returned to the first consideration of the prospective liquidation test and examined whether the corporation had planned or contemplated liquidation.¹⁷⁹ Because the corporation had no plans for liquidation, the court reasoned that a dollar-for-dollar built-in gain discount would be inappropriate.¹⁸⁰ The liability would be incurred sometime in the future, not upon an immediate liquidation.¹⁸¹ Therefore, the Tax Court concluded that an amount less than a dollar-for-dollar discount should be applied, and it adopted a figure between two figures expert witnesses proposed.¹⁸²

As the Tax Court announced its *Estate of Davis* decision in the three-month window between oral argument and the decision on the *Eisenberg* appeal, the Second Circuit followed *Estate of Davis* and vacated Judge Hamblen's earlier *Eisenberg* opinion.¹⁸³ The Second Circuit gave full expression to the significance of the *General Utilities* repeal.¹⁸⁴ It stated that the previous tax-avoidance strategies underpinning *Estate of Cruikshank* and its progeny had been foreclosed by the 1986 amendments, which had removed a corporation's ability to avoid gain recognition.¹⁸⁵ The Second Circuit also dismissed the Tax Court's reliance on gain deferral mechanisms, such as the possibility of making a subchapter S election.¹⁸⁶ Accordingly, the Second Circuit allowed the built-in gain discount.¹⁸⁷ It remanded the case to the Tax Court for determination of the discount,¹⁸⁸ noting that a dollar-for-dollar discount would be inappropriate.¹⁸⁹

178. *Id.* at 553.

179. *Id.* at 552-53.

180. *Id.* at 552.

181. *Id.*

182. *Id.* at 552-54.

183. *Eisenberg v. Comm'r*, 155 F.3d 50, 59 (2d Cir. 1998).

184. *Id.* at 54-59.

185. *Id.* at 54-55. The Second Circuit rejected possible avoidance strategies, such as holding the property, entering a nonrecognition transaction, or making an I.R.C. § 1362(a) election. *Id.* at 56-57.

186. *See id.* at 56 n.14.

187. *Id.* at 59.

188. *Eisenberg v. Comm'r*, 155 F.3d 50, 59 (2d Cir. 1998).

189. *Id.* at 58 n.15. The Second Circuit did not reach a conclusion as to the proper amount of the discount; instead, it left such determination to the Tax Court. However, the Second Circuit noted that a dollar-for-dollar discount would not be appropriate. It stated, "One might conclude . . . that the full amount of the potential capital gains tax should be subtracted from what would otherwise be the fair market value of the real estate. This would not be a correct conclusion." *Id.* *See also* *Estate of Welch v. Comm'r*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. 2000)

C. The Current Debate

What has emerged following the decisions in *Estate of Davis* and *Eisenberg* is a shift in the debate over the built-in gain discount. The question no longer focuses on whether the discount is permissible; instead, the battle now centers on how much of a discount should be allowed. Consistent with *Estate of Davis* and *Eisenberg*, the IRS argues, and the Tax Court agrees, that the amount allowed should be less than the dollar-for-dollar discount.¹⁹⁰ The Courts of Appeals for the Fifth and Eleventh Circuits have held otherwise.¹⁹¹

First, in *Estate of Jameson v. Commissioner*,¹⁹² the Fifth Circuit permitted a dollar-for-dollar built-in gain discount.¹⁹³ *Estate of Jameson* involved the value of the decedent's shares in Johnco, a closely-held corporation, the principal asset of which was timber property.¹⁹⁴ Because the corporation took a conservative stance toward harvesting the timber, the high value of the older mature trees resulted in significant built-in gain.¹⁹⁵ The Tax Court acknowledged this built-in gain would require a HWS to accept less than the timber's undiscounted fair market value.¹⁹⁶ Based upon expert testimony, the Tax Court found a HWB would expect a twenty percent return on investment in other similar timber property, and that Johnco's timber was producing a fourteen percent return on investment.¹⁹⁷ The Tax Court used these rates and a nine-year turn-over rate to discount to present value the future tax liability and applied the discount accordingly.¹⁹⁸

(unpublished table decision). In *Estate of Welch*, the Sixth Circuit reversed the Tax Court's denial of the built-in gain discount. See *Estate of Welch v. Comm'r*, 75 T.C.M. (CCH) 2252, 2256 (1998). The Sixth Circuit cited the *Eisenberg* approach with approval and remanded to the Tax Court for further factual findings. *Estate of Welch*, 2000 U.S. App. LEXIS 3315.

190. *Estate of Litchfield v. Comm'r*, 97 T.C.M. (CCH) 1079 (2009); *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) 1397 (2005), *rev'd*, 507 F.3d 1317 (11th Cir. 2007); *Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337 (2000), *rev'd*, 301 F.3d 339 (5th Cir. 2002); *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383 (1999), *rev'd*, 267 F.3d 366 (5th Cir. 2001).

191. *Estate of Jelke v. Comm'r*, 507 F.3d 1317, 1333 (11th Cir. 2007); *Estate of Dunn v. Comm'r*, 301 F.3d 339, 352-53 (5th Cir. 2002); *Estate of Jameson v. Comm'r*, 267 F.3d 366, 372 (5th Cir. 2001).

192. 267 F.3d at 366.

193. *Id.*

194. *Id.* at 368.

195. *Estate of Jameson*, 77 T.C.M. (CCH) at 1385-86.

196. *Id.* at 1396.

197. *Id.* at 1396-97.

198. *Id.* at 1396-97. The Tax Court considered how long it would take for the corporation to sell the current timber and purge the corporation of the valuation date built-in gain. *Id.* at 1396. The court then discounted to present value the amount of tax that would be incurred in each subsequent year. *Id.* at 1396-97. As discussed *infra* text § IV.D., discounting the future gain to

The Fifth Circuit overruled the Tax Court.¹⁹⁹ Because a HWB would expect a twenty percent return on a similar investment, the fourteen percent return Johnco was yielding would force a HWB to immediately liquidate the corporation.²⁰⁰ By so doing, the HWB could use the sale proceeds to reinvest and obtain a higher return on other similar investments.²⁰¹ As the HWB would immediately liquidate, the tax liability on the built-in gain would arise on the date of the hypothetical liquidation.²⁰² Accordingly, the value of the corporation would be reduced by the liability on the recognized gain. The Fifth Circuit remanded to the Tax Court, implying a dollar-for-dollar discount would be required.²⁰³

Estate of Jameson served as precedent when the Fifth Circuit ruled on the built-in gain discount in *Estate of Dunn v. Commissioner*.²⁰⁴ The decedent owned approximately sixty-three percent of the shares in Dunn Equipment, a corporation engaged in renting construction equipment.²⁰⁵ Dunn Equipment also had several employees who operated the equipment, and the company charged for their services.²⁰⁶ The corporation's operating and holding components were valued respectively using the income approach and the net asset value approach.²⁰⁷

After determining the proper weight to be placed on the operating component and the holding component, the Tax Court considered the availability of the built-in gain discount under the net asset value approach.²⁰⁸ The Tax Court received expert testimony stating that because the return on investment in Dunn Equipment was lower than what a HWB could derive from lower-risk investments,²⁰⁹ the HWB

present value fails to accurately account for the impact of the built-in gain on the value of the corporation.

199. *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001).

200. *Id.* at 372.

201. *See id.*

202. The date of the hypothetical liquidation would have been the decedent's date of death.

See id.

203. *Id.*

204. *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002).

205. *Id.* at 343-44.

206. *Id.* at 344.

207. *Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, 1339-41 (2000), *rev'd on other grounds*, 301 F.3d 339 (5th Cir. 2002).

208. *Id.* at 1344-45.

209. The taxpayer could have received a higher yield from risk-free government bonds. *Id.* at 1340.

would liquidate the company.²¹⁰ However, at issue was a sixty-three percent interest, and under Texas law, a two-thirds vote was necessary to cause liquidation.²¹¹ Other investors were committed to the company as a going concern.²¹² Therefore, the Tax Court ruled that the HWB's inability to cause liquidation required a lower built-in gain discount than the dollar-for-dollar discount the taxpayer's expert had urged.²¹³

The Fifth Circuit disagreed.²¹⁴ It held that the taxpayer was entitled to a dollar-for-dollar discount.²¹⁵ The court reasoned that under the net asset value approach, one must assume the HWB purchases the corporate shares to obtain ownership of the underlying assets.²¹⁶ Proper valuation thus requires *as a matter of law* that a hypothetical liquidation occur on the valuation date, giving rise to a dollar-for-dollar discount.²¹⁷ In response to the Tax Court's inquiry into the probability of liquidation, the Fifth Circuit stated that such a consideration is inappropriate under the net asset value approach.²¹⁸ Because the net asset value approach, according to the court, presumes liquidation on the valuation date,²¹⁹ the "likelihood" of liquidation is 100 percent.²²⁰

In the most recent appellate decision,²²¹ the Court of Appeals for the Eleventh Circuit followed the Fifth Circuit. It allowed a dollar-for-dollar discount in *Estate of Jelke v. Commissioner*,²²² where a family-owned C corporation valued under the net asset value approach held about \$179 million in marketable securities and \$10 million in other

210. *Id.*

211. *Id.*

212. *Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, 1340 (2000), *rev'd on other grounds*, 301 F.3d 339 (5th Cir. 2002).

213. *Id.* at 1344-45. The Tax Court allowed a five percent discount, whereas the taxpayer had argued for a thirty-four percent discount. *Id.* Note that whether the HWB can actually liquidate the corporation should not be considered in calculating the amount of the built-in gain discount. The inability to liquidate should instead be considered a part of the lack of control discount. *See infra* text § IV.D.

214. *Estate of Dunn v. Comm'r*, 301 F.3d 339, 352 (5th Cir. 2002).

215. *Id.* at 352-53.

216. *Id.* at 353.

217. *Id.* at 352-53.

218. *Id.* at 354. However, the court did find the likelihood of liquidation relevant in determining the respective weight to be placed on the operating component and the holding component—if liquidation is unlikely, the operating component may be weighted more heavily. *Id.*

219. The analysis below demonstrates that this assumption is incorrect. *See infra* text § IV.B.

220. *Estate of Dunn*, 301 F.3d at 353.

221. *See Estate of Litchfield v. Comm'r*, 97 T.C.M. (CCH) 1079 (2009), discussed *infra* note 245, for discussion of the most recent Tax Court opinion addressing built-in discounts.

222. *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007), *rev'g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008).

assets.²²³ The built-in tax liability on these assets was about \$51 million.²²⁴ The corporation's primary objective was long-term capital growth, which resulted in a relatively low turn-over rate and large built-in gains.²²⁵

In the Tax Court, the taxpayer argued for a dollar-for-dollar discount, reasoning that *Estate of Dunn* required such an approach as a matter of law.²²⁶ Invoking the *Golsen* rule,²²⁷ the Tax Court held that it was not bound by *Estate of Dunn*, as the taxpayer's appeal would not be heard in the Fifth Circuit.²²⁸ The Tax Court instead reasoned that assuming a HWB would liquidate would be erroneous, as the corporation's investments were outperforming the market.²²⁹ Instead of permitting the dollar-for-dollar discount, the Tax Court relied on the discounted present value calculations of the government's expert.²³⁰ The expert calculated the average asset turn-over rate and found that it would take about sixteen years for the corporation to purge the date of death built-in gain.²³¹ Dividing the total built-in gain by sixteen, the expert discounted to present value the tax liability that would be payable on the gain recognized over the sixteen-year period, and the Tax Court allowed the discount accordingly.²³²

On appeal, the Eleventh Circuit reversed the Tax Court and remanded with instructions to apply a dollar-for-dollar discount.²³³ The Eleventh Circuit criticized the Tax Court's choice of the sixteen-year period over which the gain would be recognized, stating that only a

223. *Id.* at 1319.

224. *Id.*

225. *Id.*

226. *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) 1397, 1403 (2005), *rev'd*, 507 F.3d 1317 (2007) (citing *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002)).

227. *See Golsen v. Comm'r*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The *Golsen* rule stands for the proposition that the Tax Court will be bound only by federal court of appeals decisions that are controlling in the jurisdiction to which the taxpayer would appeal. *Id.* at 757. The Tax Court does not consider as binding federal court of appeals decisions from jurisdictions where the taxpayer's appeal would not lie. *See id.*

228. *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) at 1403 (citing *Estate of Dunn*, 301 F.3d 339 (5th Cir. 2002)).

229. *Id.*

230. *Id.* at 1404.

231. *Id.* at 1402.

232. *Id.* at 1402-03. This approach, though arguably more accurate than the dollar-for-dollar approach, is also problematic because it ignores the appreciation in the assets. By simply freezing the built-in gain on the valuation date, calculating the corresponding liability, and discounting that liability to present value, this approach overlooks the extent to which the built-in gain will impair the net future value of the investment. *See infra* text § IV.C.

233. *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007), *rev'g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008).

strategic buyer and not a HWB would take such an approach.²³⁴ Instead, the court ruled that the value of the assets and liabilities should be frozen on the valuation date and adopted the “arbitrary assumption” that a hypothetical liquidation take place on the date of death.²³⁵ Stressing the lack of precise rules for calculating the built-in gain discount, the court adopted this bright-line test, echoing the Fifth Circuit’s recognition that such an approach might be criticized as “unsophisticated, dogmatic, overly simplistic, or just plain wrong.”²³⁶

In a robust dissent, Judge Carnes denounced the majority’s approach.²³⁷ The dissent accused the majority of adopting “the judicial equivalent of the doctrine of ignoble ease.”²³⁸ This criticism implied that the majority failed to labor toward a more accurate calculation, opting instead to assume a hypothetical liquidation. For Judge Carnes, the Tax Court’s approach might not have been perfect, but it was a better estimation of the value a HWB would have paid for the decedent’s stock.²³⁹ The dissent emphasized that although the majority’s holding would give rise to greater judicial efficiency, the court ought not to forsake the correct answer for the expedient one.²⁴⁰ Judge Carnes concluded by dissenting from the majority’s “perilous delusion.”²⁴¹

Dissatisfied with the Eleventh Circuit’s “arbitrary assumption,” the Commissioner petitioned the Supreme Court for writ of certiorari.²⁴² The petition asserted that the Eleventh Circuit erred, first, by failing to

234. *Id.* at 1331.

235. *Id.*

236. *Id.* at 1333 (citing *Estate of Dunn v. Comm’r*, 301 F.3d 339, 358 n.36 (5th Cir. 2002)).

237. *Id.* at 1333-40 (Carnes, J. dissenting).

238. *Id.* at 1334. Judge Carnes quoted Teddy Roosevelt as saying:

I wish to preach not the doctrine of ignoble ease but the doctrine of the strenuous life; the life of toil and effort; of labor and strife; to preach that highest form of success which comes not to the man who desires mere easy peace but to the man who does not shrink from danger, from hardship, or from bitter toil, and who out of these wins the splendid ultimate triumph.

Estate of Jelke v. Comm’r, 507 F.3d 1317, 1334 (11th Cir. 2007), *rev’g*, 89 T.C.M. (CCH) 1397 (2005), *cert. denied*, 129 S. Ct. 168 (2008) (quoting Vice President Theodore Roosevelt, *The Doctrine of the Strenuous Life* (April 10, 1899) in *THE PENGUIN BOOK OF TWENTIETH-CENTURY SPEECHES 1* (Brian MacArthur, ed., Penguin Books, 1992)).

239. *Id.* at 1335.

240. *Id.* at 1337. In addition to lamenting the implications of the majority opinion in the estate tax area, Judge Carnes criticized the opinion as having a negative ramification for other areas of law where complex calculations are required. *Id.* at 1337-40.

241. *Id.* at 1340.

242. *Petition for Writ of Certiorari, Comm’r v. Estate of Jelke*, 129 S. Ct. 168 (2008) (No. 07-1582).

conduct the valuation of the corporation's stock as a factual inquiry, and, second, by requiring a dollar-for-dollar discount as a matter of law.²⁴³ The Court denied the Commissioner's petition.²⁴⁴

Although consensus now exists between the Fifth Circuit and the Eleventh Circuit, the Tax Court's opinions reflect an unwillingness to adopt as a matter of law the dollar-for-dollar discount. Indeed, shortly after the Supreme Court denied *certiorari* in *Estate of Jelke*, the Tax Court again permitted a built-in gain discount that was less than the full dollar-for-dollar amount.²⁴⁵ Moreover, the decisions rendered by the Fifth Circuit and the Eleventh Circuit are at odds with the Second Circuit, which stated in *Eisenberg* that the dollar-for-dollar built-in gain discount would be inappropriate.²⁴⁶ Although the Court of Appeals for the Sixth Circuit's unpublished 2000 opinion in *Welch v. Commissioner*, which adopted the *Eisenberg* approach,²⁴⁷ does not represent binding precedent, the decision indicates that the Sixth Circuit may be reluctant to follow *Estate of Dunn* and *Estate of Jelke*. In light of the fact that the Commissioner has refused to concede and the split among the circuits remains significant, the issue is ripe for resolution.²⁴⁸ However, as the Supreme Court has refused to provide this much-needed guidance, federal appellate courts will be left to resolve issues of first impression in their respective circuits.

Any resolution must balance two competing interests. On the one hand, *Estate of Dunn* and *Estate of Jelke* recognize that a precise calculation of the discount in every case is cumbersome. The judicial

243. *Id.*

244. *Estate of Jelke v. Comm'r*, 129 S. Ct. 168 (2008).

245. *Estate of Litchfield v. Comm'r*, 97 T.C.M. (CCH) 1079 (2009). In contrast to other recent cases, in *Estate of Litchfield*, the taxpayer did not argue for the full dollar-for-dollar amount. Because the Second Circuit would have jurisdiction over the taxpayer's appeal, the taxpayer's appraiser presumably yielded to *Eisenberg* in not claiming a dollar-for-dollar discount. However, the taxpayer successfully argued for a built-in gain discount in a closely-held C corporation equal to approximately ninety-one percent of the full dollar-for-dollar amount. The taxpayer also successfully argued for a built-in gain discount for stock in an S corporation, predicting that some of the S corporation's assets would be sold within ten years of having made a § 1362(a) election and would thereby incur corporate level tax. Although the *Estate of Litchfield* opinion appropriately recognizes that post-transfer appreciation will have some impact on the amount of the built-in gain discount, it still seems to miss the mark by focusing on the relationship between this appreciation and the future tax liability rather than on the impact of the built-in gain on net future cash value of the investment. See *infra* text § IV.C.

246. See *supra* note 189 and accompanying text.

247. See *Estate of Welch v. Comm'r*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. 2000) (unpublished table decision).

248. See Robert Willens, *Eleventh Circuit in Jelke Offers Taxpayer-Friendly Resolution for Estate Valuation Issues Post-TRA 1986*, 26 TAX MGM'T. WEEKLY REPORT 1736, 1737 (2007).

resources required to properly adjudicate the intricate mathematics are substantial. However, as Judge Carnes's dissent makes clear, courts are charged with the duty of rendering just and accurate decisions, even when such decisions require a "life of toil and effort."²⁴⁹ Balancing these competing objectives is challenging but possible. By reconsidering the precedent established by *Estate of Cruikshank* and its progeny, a test can be fashioned to decide cases in both an efficient and accurate manner.

IV. A MODIFIED LIQUIDATION TEST

A. Conceptual Foundation

Part of the divergence among the circuits arguably arises from their failure to consider the possible continuing influence of the prospective liquidation test. Although repeal of the *General Utilities* doctrine antiquated the prospective liquidation test, the logical foundation of the test should have survived. The prospective liquidation test ought not to be thrown out; instead, it should be modified to respond to the change in corporate tax law. To reshape the prospective liquidation test, two modifications are in order.

First, the prospective liquidation test was flawed from the outset because of the approach taken under its first consideration. By looking at whether at the time of the transfer the corporation had plans to liquidate the underlying assets, courts erroneously examined the problem from the viewpoint of the actual shareholders rather than from the viewpoint of the HWB.²⁵⁰ The characteristics of the actual shareholders might not mirror the characteristics of the HWB.²⁵¹ For example, actual shareholders might be influenced by family ties, overly optimistic predictions of future performance, or risk aversion. These influences could prevent liquidation in circumstances under which such liquidation might yield greater economic benefits. A HWB would not be so encumbered. Instead, the HWB would engage in a mechanistic analysis of the future value of the investment to determine what course of action is economically superior.²⁵² Courts should use such an approach as the

249. *Estate of Jelke*, 507 F.3d at 1334 (Carnes, J, dissenting).

250. See VALUATION, *supra* note 21, ¶ 6.03[6][c], at 6-50 to 6-56.

251. See *supra* note 28 and accompanying text.

252. See *supra* note 32 and accompanying text.

first consideration of the modified liquidation test to determine whether the HWB has an incentive to liquidate.

Second, under the prospective liquidation test, courts considered whether future liquidation could be performed without recognizing gain.²⁵³ Under the modified liquidation test, the inquiry is not whether gain will be recognized; rather, it is a question of when recognition will occur. The result of the first consideration conditions the outcome of the second. If the HWB has the incentive to liquidate immediately, then gain will be recognized immediately. In such circumstances, the dollar-for-dollar approach would be appropriate. If the HWB has the incentive to retain assets within the corporation, then the gain will be recognized in the future. In this case, an amount less than the dollar-for-dollar discount would be the accurate result. Thus, the second consideration of the modified liquidation test would require courts to calculate the amount of the discount by first considering the HWB's incentive to liquidate.

Evaluating the HWB's course of action requires an analysis of the tax consequences of distributing the corporation's assets, either in kind or as cash sale proceeds, to the HWB. Because the tax consequences of every corporate distribution²⁵⁴ cannot be generalized, judicial application of the modified liquidation test may be complex in some circumstances. Driving this complexity is whether the distribution is taxed as a dividend or as a sale or exchange.

As a basic rule, corporate distributions are treated as dividends.²⁵⁵ Determining the amount of the dividend requires a computation of the corporation's earnings and profits.²⁵⁶ To the extent that current and accumulated earnings and profits are less than the amount of the distribution, the distribution is treated first as a recovery of capital and then as taxable gain.²⁵⁷ Two exceptions circumvent dividend treatment. First, § 302(b) provides that certain corporate distributions in redemption of a shareholder's stock may be treated as a sale or exchange of the

253. See *supra* note 100 and accompanying text.

254. Because of complexities in corporate tax law, the meanings of the terms "distribution" and "liquidation" are important to note. A distribution is any transfer of property, including money, to a shareholder in respect to the shareholder's stock. A distribution can also be a part of a liquidation. The shareholder can liquidate the shareholder's interest in the corporation by receiving a distribution in complete redemption of the shareholder's interest in the corporation. The corporation can liquidate all of its assets, either by distributing the assets in-kind or by selling the assets and distributing the cash proceeds.

255. See I.R.C. §§ 301(c) and 316; see also I.R.C. § 312.

256. See I.R.C. § 316.

257. I.R.C. § 301(c).

stock.²⁵⁸ Second, § 331 provides that distributions made to a shareholder in complete liquidation of a corporation are deemed to be received in exchange for the stock.²⁵⁹

Distinguishing between dividend treatment and sale or exchange treatment is important because it influences the amount of the distribution that is taxed. Where a taxpayer receives a dividend and there are sufficient earnings and profits, the entire amount of the distribution is taxed,²⁶⁰ where a taxpayer receives sale or exchange treatment, tax is imposed on the amount by which the distribution exceeds the taxpayer's basis in the stock.²⁶¹ Typically, an individual taxpayer prefers sale or exchange treatment because the immediate recovery of capital results in less tax liability.²⁶² For reasons discussed below,²⁶³ the ensuing analysis treats any distribution to the HWB as occurring either in liquidation of the HWB's interest in the corporation, thereby receiving sale or exchange treatment under § 302(b)(3), or in liquidation of the entire corporation, thereby receiving sale or exchange treatment under § 331.

B. Determining the Incentive to Liquidate

Whether the HWB would immediately liquidate depends on what course of action places the HWB in the best economic position, as the HWB is presumed to maximize economic welfare. The HWB will choose the option that yields the highest net future value. To select the optimal choice, the HWB must first make certain threshold determinations. The HWB must know the current value of the corporation's underlying assets and the corporation's basis in those assets. Next, the HWB must determine the rate at which the corporation's assets are appreciating and the rate that the market would

258. Sale or exchange treatment is provided in the following circumstances: under I.R.C. § 302(b)(1), where the redemption is not essentially equivalent to a dividend; under I.R.C. § 302(b)(2), where the redemption is substantially disproportionate compared to the redemption of other shareholders' interests; under I.R.C. § 302(b)(3), where the redemption terminates the shareholder's interest in the corporation; under I.R.C. § 302(b)(4), where the redemption is in partial liquidation of the corporation.

259. I.R.C. § 331(a).

260. See I.R.C. §§ 301(c), 312, and 316.

261. See I.R.C. §§ 302(b) and 1001.

262. Because of the immediate recovery of capital, this is true even when dividends are taxed at the preferential 26 U.S.C. § 1(h) rate. The preference for sale or exchange treatment will increase if the preferential dividend rate sunsets on December 31, 2009 as scheduled. See Jobs and Growth Tax Relief and Reconciliation Act of 2003, Pub. L. No. 108-27, § 303, 117 Stat. 752, 764.

263. See *infra* text § IV.D.

provide for an investment of similar risk and duration. The HWB must also project a holding period for which the assets or proceeds will be invested. Finally, the HWB will apply the corporate and individual rates at which gains on these assets would be taxed. The HWB can then calculate the net future cash value of the investment as of the end of the holding period.²⁶⁴ These factually determined values and the calculated values for which they are relevant appear in Figure 1. Importantly, courts regularly determine these values during valuation proceedings.²⁶⁵ Once these values are ascertained, the HWB has four options for converting the corporation's assets into future cash.²⁶⁶

Figure 1

Provided:	
<i>CV</i>	Current value of assets
<i>AB In</i>	Corporation's adjusted basis in its assets
<i>ra</i>	Asset appreciation rate
<i>rm</i>	Market appreciation rate
<i>n</i>	Projected holding period
<i>Rco</i>	Corporate income tax rate (35% rate assumed)
<i>Rind</i>	Individual income tax rate (15% rate assumed)
Calculated:	
<i>AB Out</i>	HWB's basis
<i>Gain In</i>	Corporation's gain recognized
<i>Gain Out</i>	HWB's gain recognized
<i>Net CV In</i>	Net current value to corporation
<i>Net CV Out</i>	Net current value to HWB
<i>FV</i>	Future value of assets
<i>Net FV In</i>	Net future value to corporation
<i>Net FV Out</i>	Net future cash value to HWB
<i>d</i>	Discount (as a percent)
<i>DCV</i>	Discounted current value

264. Note that many of the initial values may change during the period the HWB anticipates holding the investment. For example, the asset appreciation rate and the market appreciation rate are likely to vary significantly over time. However, the relevant determination must be made as of the valuation date. Future fluctuations are irrelevant, as valuation occurs on the valuation date with all relevant information known or reasonably foreseeable as of that date.

265. See *infra* notes 314-316 and accompanying figures.

266. The ensuing discussion assumes that the HWB has sufficient voting control to determine the corporation's actions. This assumption is for hypothetical purposes only, however, and if the actual shares the HWB owns are insufficient to control the corporation, further adjustments can be made with a lack of control discount as discussed *infra* text § IV.D.

First, the HWB can select an “asset sale” option by selling the corporation’s assets, reinvesting the proceeds to acquire new corporate assets, selling the new assets at the end of the projected holding period, and distributing the cash proceeds from the corporation. To determine net future cash value, the HWB must first calculate the consequences of incurring gain on the sale of the underlying assets. This gain will equal the value of the assets less the corporation’s adjusted basis in the assets.²⁶⁷ The gain will be taxed at the corporate tax rate,²⁶⁸ and the corporation will be left with net proceeds equal to the value of the assets less the tax incurred.²⁶⁹ Once the corporation holds the net proceeds, it will reinvest. The corporation must determine the rate of return the market would provide²⁷⁰ for an investment of similar risk to the corporation’s original assets. The future value of the new investment will be a function of this market appreciation rate and the projected holding period.²⁷¹ When the corporation sells these assets at the end of the projected holding period, the corporation will recognize gain²⁷² subject to corporate level tax.²⁷³

The corporation will then distribute the net proceeds.²⁷⁴ Under § 302(b)(3) or § 331,²⁷⁵ the HWB will recognize gain or loss equal to the net proceeds distributed less the HWB’s basis in the stock.²⁷⁶ The HWB’s § 1012 cost basis will equal the hypothetical purchase price, which is the stock’s discounted current value.²⁷⁷ Because the discounted current value under the asset sale option will always be determined with a dollar-for-dollar discount on account of the fact that the gain is triggered immediately, the discounted current value equals the net current value in the corporation following gain recognition and payment of tax.²⁷⁸ This gain is taxed at the applicable individual capital gains

267. Calculated as $Gain\ In = CV - AB\ In$.

268. Calculated as $Tax = Gain\ In \times Rco$.

269. Calculated as $Net\ CV\ In = CV - Tax$.

270. Represented as rm .

271. Calculated as $FV = Net\ CV\ In \times (1 + rm)^n$.

272. Calculated as $Gain\ In = FV - AB\ In$. Note that the new $AB\ In$ would equal $Net\ CV\ In$ as the corporation would have reinvested the net sale proceeds, taking a § 1012 cost basis.

273. Calculated as $Tax = Gain\ In \times Rco$.

274. Calculated as $Net\ FV\ In = FV - Tax$.

275. See *supra* text § IV.A.

276. Calculated as $Gain\ Out = Net\ FV\ In - AB\ Out$.

277. Represented as $AB\ Out = DCV$.

278. Calculated as $Net\ CV\ In = AB\ Out = DCV$. Technically, the calculation is more complex than this. Because $AB\ Out$ equals DCV , the computation of $AB\ Out$ and of d requires the isolation of an interdependent variable. However, this is easily resolved because under the corporate liquidation model, d always equals $Rco \times (CV - AB\ In)$, which allows for the isolation d as the

rate,²⁷⁹ and the HWB has cash-in-hand equal to the distributed proceeds less the HWB's tax.²⁸⁰ Figure 2A demonstrates the calculation of net future cash value where current value equals \$200,000, the corporation's basis in its assets equals \$10,000, and the market appreciation rate equals ten percent.

Figure 2A

 $rm = 10\%; n = 5$

	Asset Sale
<i>CV</i>	200,000
<i>AB In</i>	(10,000)
<i>Gain In</i>	190,000
<i>Tax (Rco)</i>	(66,500)
<i>Net CV In</i>	133,500
<i>AB Out</i>	(133,500)
<i>Gain Out</i>	--
<i>Tax (Rind)</i>	--
<i>Net CV Out</i>	--
<i>FV</i>	215,003
<i>AB In</i>	(133,500)
<i>Gain In</i>	81,503
<i>Tax (Rco)</i>	(28,526)
<i>Net FV In</i>	186,477
<i>AB Out</i>	(133,500)
<i>Gain Out</i>	52,977
<i>Tax (Rind)</i>	(7,947)
<i>Net FV Out</i>	178,530

Figure 2B

 $rm = 10\%; n = 5$

	Cash Liq.
<i>CV</i>	200,000
<i>AB In</i>	(10,000)
<i>Gain In</i>	190,000
<i>Tax (Rco)</i>	(66,500)
<i>Net CV In</i>	133,500
<i>AB Out</i>	(133,500)
<i>Gain Out</i>	0
<i>Tax (Rind)</i>	(0)
<i>Net CV Out</i>	133,500
<i>FV</i>	215,003
<i>AB In</i>	--
<i>Gain In</i>	--
<i>Tax (Rco)</i>	--
<i>Net FV In</i>	--
<i>AB Out</i>	(133,500)
<i>Gain Out</i>	81,503
<i>Tax (Rind)</i>	(12,225)
<i>Net FV Out</i>	202,778

Second, the HWB can choose a "cash liquidation" option by selling the underlying assets, distributing the proceeds, reinvesting the proceeds to acquire new assets outside the corporation, and cashing out at the end

interdependent variable, which leads to the calculation of *DCV*. *DCV* equals $CV \times (1-d)$, which in turn equals *AB Out*.

279. Calculated as $Tax = Gain Out \times Rind$.

280. Calculated as $Net FV Out = Net FV In - Tax$. This option is advantageous only when the corporate tax rate is lower than the HWB's individual rate. Because corporate rates exceed the preferential fifteen percent capital gain rate, this option is of minor importance under current law.

of the projected holding period. Under this option, the HWB would again calculate gain on the sale of the underlying assets, which equals the value of the assets less the corporation's basis in the assets.²⁸¹ The gain will be taxed at the corporate tax rate,²⁸² and the corporation will retain net proceeds equal to the value of the assets less the tax incurred.²⁸³

Next, the HWB must determine the tax consequences of distributing the net proceeds. Under § 302(b)(3) or § 331,²⁸⁴ the HWB will recognize gain or loss equal to the distributed net proceeds less the HWB's basis in the stock.²⁸⁵ Again, the HWB's § 1012 cost basis in the stock will equal the hypothetical purchase price, which is the stock's discounted current value.²⁸⁶ The discounted current value under the cash liquidation option will always be determined with a dollar-for-dollar discount. Therefore, the discounted current value equals the net current value in the corporation following gain recognition and payment of tax.²⁸⁷ For this reason, the HWB will always have zero gain recognized on the distribution.

Once the HWB has the net proceeds in hand, the HWB will reinvest. The future value of this investment will be a function of the market appreciation rate and the projected holding period.²⁸⁸ At the end of the projected holding period, the HWB will be taxed directly on the gain as the investment is held outside the corporation. The gain will equal the future value of the investment less the net proceeds the HWB reinvested.²⁸⁹ The gain will be subject to tax at the HWB's rates,²⁹⁰ and the net future cash value will equal the future value less the tax.²⁹¹ Figure 2B demonstrates the application of this option.

Third, the HWB can engage in an "in-kind liquidation" option. The calculation of the net future cash value under this option is identical to the second option, with one exception. Rather than receiving a distribution of cash proceeds, the HWB receives the actual underlying

281. Calculated as $Gain\ In = CV - AB\ In$.

282. Calculated as $Tax = Gain\ In \times Rco$.

283. Calculated as $Net\ CV\ In = CV - Tax$.

284. See *supra* text § IV.A.

285. Calculated as $Gain\ Out = Net\ CV\ In - AB\ Out$.

286. Represented as $AB\ Out = DCV$.

287. Calculated as $Net\ CV\ In = AB\ Out = DCV$. See *supra* note 278.

288. Calculated as $FV = Net\ CV\ Out \times (1 + rm)^n$.

289. Calculated as $Gain\ Out = FV - AB\ Out$. Note that $Net\ CV\ Out$ would be the HWB's new $AB\ Out$.

290. Calculated as $Tax = Gain\ Out \times Rind$.

291. Calculated as $Net\ FV\ Out = FV - Tax$.

assets.²⁹² Thus, instead of reinvesting the cash proceeds at the prevailing market appreciation rate, the HWB will hold the original assets from the in-kind liquidation, which will appreciate at the asset appreciation rate.²⁹³ Figure 2C demonstrates the application of this option.

Fourth, the HWB can simply retain the assets inside the corporation, sell the assets at the end of the projected holding period, and then distribute the proceeds net of corporate tax. Under this “asset hold” option, there is no initial tax incurred. Instead, the current value of the assets increases over the projected holding period at the asset appreciation rate, and the future value of the assets remains in the corporation.²⁹⁴ At the end of the projected holding period, the corporation will sell the assets and distribute the cash proceeds to the HWB. The sale results in gain recognition²⁹⁵ and corporate tax liability.²⁹⁶ The HWB receives a cash distribution of the net future value inside the corporation.²⁹⁷

Under § 302(b)(3) or § 331,²⁹⁸ the HWB will recognize gain or loss on receipt of the distribution. The HWB’s basis in the stock will be a § 1012 cost basis equal to the hypothetical purchase price, which is the stock’s discounted current value.²⁹⁹ This creates the problem of an interdependent variable as the discounted current value is a function of the HWB’s basis and the basis is a function of the discounted current value. To resolve this, the discount can be represented algebraically without regard to the HWB’s basis, and the discounted current value can be computed accordingly.³⁰⁰

292. This means that the corporation does not recognize gain as the result of actually selling the asset. Instead I.R.C. § 311 or I.R.C. § 336 would dictate the corporate level recognition event. Where I.R.C. § 311 applies, the corporation recognizes gain on the in-kind distribution. Where I.R.C. § 336 applies, the corporation recognizes gain on distributions in complete liquidation. Note that this assumes that I.R.C. § 301 does not apply, the rationale for which is discussed *infra* text § IV.D. It also assumes severability of the assets such that the corporation can pay the tax. Where the asset is not severable, the HWB must be presumed to transfer sufficient cash to the corporation to pay the liability.

293. Under the cash liquidation option, FV was calculated as $Net\ CV\ In \times (1 + rm)^n$. See *supra* note 271 and accompanying text. Under the in-kind liquidation option, FV is calculated as $Net\ CV\ In \times (1 + ra)^n$. A difference in future value results if rm differs from ra . See *infra* Figure 6A.

294. Calculated as $FV = CV \times (1 + ra)^n$.

295. Calculated as $Gain\ In = FV - AB\ In$.

296. Calculated as $Tax = Gain\ In \times Rco$.

297. Calculated as $Net\ FV\ In = FV - Tax$.

298. See *supra* text § IV.A.

299. Represented as $AB\ Out = DCV$.

300. See *infra* note 324 and accompanying text.

Figure 2C
 $ra = 10\%$; $n = 5$

	In-Kind Liq.
<i>CV</i>	200,000
<i>AB In</i>	<u>(10,000)</u>
<i>Gain In</i>	190,000
<i>Tax (Rco)</i>	<u>(66,500)</u>
<i>Net CV In</i>	133,500
<i>AB Out</i>	<u>(133,500)</u>
<i>Gain Out</i>	0
<i>Tax (Rind)</i>	<u>(0)</u>
<i>Net CV Out</i>	133,500
<i>FV</i>	215,003
<i>AB In</i>	<u>--</u>
<i>Gain In</i>	--
<i>Tax (Rco)</i>	<u>--</u>
<i>Net FV In</i>	--
<i>AB Out</i>	<u>(133,500)</u>
<i>Gain Out</i>	81,503
<i>Tax (Rind)</i>	<u>(12,225)</u>
<i>Net FV Out</i>	202,778

Figure 2D
 $ra = 10\%$; $n = 5$

	Asset Hold
<i>CV</i>	200,000
<i>AB In</i>	<u>(10,000)</u>
<i>Gain In</i>	--
<i>Tax (Rco)</i>	<u>--</u>
<i>Net CV In</i>	200,000
<i>AB Out</i>	<u>(152,392)</u>
<i>Gain Out</i>	--
<i>Tax (Rind)</i>	<u>--</u>
<i>Net CV Out</i>	--
<i>FV</i>	322,102
<i>AB In</i>	<u>(10,000)</u>
<i>Gain In</i>	312,102
<i>Tax (Rco)</i>	<u>(109,236)</u>
<i>Net FV In</i>	212,866
<i>AB Out</i>	<u>(152,392)</u>
<i>Gain Out</i>	60,474
<i>Tax (Rind)</i>	<u>(9,071)</u>
<i>Net FV Out</i>	203,795

Once this value is known, the HWB can calculate gain on the distribution,³⁰¹ which will be subject to tax.³⁰² The net future cash value will thus equal the net future value inside the corporation less the tax liability that the HWB incurs upon receipt of the distribution.³⁰³ Figure 2D demonstrates this option.

301. Calculated as $Gain\ Out = Net\ FV\ In - AB\ Out$.

302. Calculated as $Tax = Gain\ Out \times Rind$.

303. Calculated as $Net\ FV\ Out = Net\ FV\ In - Tax$. The same result would arise if the corporation were to distribute the assets in-kind, as the corporation would recognize gain under I.R.C. § 311 or I.R.C. § 336. The in-kind distribution would be net of tax, and the HWB would receive a distribution equal to the future value less the tax. The HWB would take an I.R.C. § 334(a) basis in the property equal to its fair market value, and an immediate sale at fair market value would result in zero gain recognized. Following the repeal of the *General Utilities* doctrine, the gain recognition required by I.R.C. § 311 or I.R.C. § 336 foreclosed the possibility of distributing assets in-kind without recognizing gain.

Once the net future cash value under each option is determined, the HWB must compare the results.³⁰⁴ The HWB will choose the option that results in the greatest net future cash value, as that choice will maximize the HWB's economic position. Figure 2E shows this comparison. Because the asset hold option yields the highest net future cash value, \$203,795, the HWB will choose to hold the assets in the corporation. The amount of the built-in gain on the valuation date influences which option is economically superior. Because more tax liability would be immediately incurred, the benefit of deferring tax by retaining the assets inside the corporation increases when the built-in gain is larger. A comparison of Figure 2E with Figure 3A demonstrates this principle.³⁰⁵

304. The computation can be simplified by using algebraic formulae and inputting the provided values into the equations. The formulae are as follows:

For asset sale option, net future cash value equals:

$$(1 - Rind)[CV(1 - Rco) + RcoAB In][(1 - Rco)(1 + rm)^n + Rco] + CVRind \left[\frac{CV(1 - Rco) + RcoAB In}{CV(1 - Rco) + RcoCV} \right]$$

For cash liquidation option, net future cash value equals:

$$[CV(1 - Rco) + RcoAB In][(1 - Rind)(1 + rm)^n + Rind]$$

For in-kind liquidation option, net future cash value equals:

$$[CV(1 - Rco) + RcoAB In][(1 - Rind)(1 + ra)^n + Rind]$$

For asset hold option, net future cash value equals:

$$(1 - Rind)[CV(1 - Rco)(1 + ra)^n + RcoAB In] + CVRind \left[\frac{CV(1 - Rco)(1 + ra)^n + RcoAB In}{CV(1 - Rco)(1 + ra)^n + RcoCV} \right]$$

305. In Figure 2E, the built-in gain is \$190,000; the asset hold option is economically superior to the liquidation options by \$1,017, the difference between \$203,795 and \$202,778. In Figure 3A, the built-in gain is \$195,000; the asset hold option is economically superior to the liquidation options by \$2,000, the difference between \$202,119 and \$200,119. The economic benefit of \$2,000 in Figure 3A is greater than the economic benefit of \$1,017 in Figure 2E because the built-in gain in Figure 3A is larger than the built-in gain in Figure 2E.

Figure 2E

 $ra = 10\%$; $rm = 10\%$; $n = 5$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	200,000	200,000	200,000	200,000
<i>AB In</i>	(10,000)	(10,000)	(10,000)	(10,000)
<i>Gain In</i>	190,000	190,000	190,000	--
<i>Tax (Rco)</i>	(66,500)	(66,500)	(66,500)	--
<i>Net CV In</i>	133,500	133,500	133,500	200,000
<i>AB Out</i>	(133,500)	(133,500)	(133,500)	(152,392)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	133,500	133,500	--
<i>FV</i>	215,003	215,003	215,003	322,102
<i>AB In</i>	(133,500)	--	--	(10,000)
<i>Gain In</i>	81,503	--	--	312,102
<i>Tax (Rco)</i>	(28,526)	--	--	(109,236)
<i>Net FV In</i>	186,477	--	--	212,866
<i>AB Out</i>	(133,500)	(133,500)	(133,500)	(152,392)
<i>Gain Out</i>	52,977	81,503	81,503	60,474
<i>Tax (Rind)</i>	(7,947)	(12,225)	(12,225)	(9,071)
<i>Net FV Out</i>	178,530	202,778	202,778	203,795

Figure 3A
 $ra = 10\%$; $rm = 10\%$; $n = 5$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	200,000	200,000	200,000	200,000
<i>AB In</i>	(5,000)	(5,000)	(5,000)	(5,000)
<i>Gain In</i>	195,000	195,000	195,000	--
<i>Tax (Rco)</i>	(68,250)	(68,250)	(68,250)	--
<i>Net CV In</i>	131,750	131,750	131,750	200,000
<i>AB Out</i>	(131,750)	(131,750)	(131,750)	(151,139)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	131,750	131,750	--
<i>FV</i>	212,185	212,185	212,185	322,102
<i>AB In</i>	(131,750)	--	--	(5,000)
<i>Gain In</i>	80,435	--	--	317,102
<i>Tax (Rco)</i>	(28,152)	--	--	(110,986)
<i>Net FV In</i>	184,033	--	--	211,116
<i>AB Out</i>	(131,750)	(131,750)	(131,750)	(151,139)
<i>Gain Out</i>	52,283	80,435	80,435	59,977
<i>Tax (Rind)</i>	(7,842)	(12,065)	(12,065)	(8,997)
<i>Net FV Out</i>	176,190	200,119	200,119	202,119

However, where the built-in gain is smaller, the HWB's preference may shift, as a comparison of Figure 2E with Figure 4A shows.³⁰⁶ Because the built-in gain is smaller, the tax consequences of an immediate corporate-level tax are no longer a barrier to liquidating.

306. In Figure 2E, the built-in gain is \$190,000; the asset hold option is economically superior to the liquidation options by \$1,017, the difference between \$203,795 and \$202,778. In Figure 4A, the built-in gain is \$150,000; the liquidation options are economically superior to the asset hold option by \$6,844, the difference between \$224,042 and \$217,198.

Figure 4A
 $ra = 10\%$; $rm = 10\%$; $n = 5$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	200,000	200,000	200,000	200,000
<i>AB In</i>	(50,000)	(50,000)	(50,000)	(50,000)
<i>Gain In</i>	150,000	150,000	150,000	--
<i>Tax (Rco)</i>	(52,500)	(52,500)	(52,500)	--
<i>Net CV In</i>	147,500	147,500	147,500	200,000
<i>AB Out</i>	(147,500)	(147,500)	(147,500)	(162,415)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	147,500	147,500	--
<i>FV</i>	237,550	237,550	237,550	322,102
<i>AB In</i>	(147,500)	--	--	(50,000)
<i>Gain In</i>	90,050	--	--	272,102
<i>Tax (Rco)</i>	(31,518)	--	--	(95,236)
<i>Net FV In</i>	206,032	--	--	226,866
<i>AB Out</i>	(147,500)	(147,500)	(147,500)	(162,415)
<i>Gain Out</i>	58,532	90,050	90,050	64,451
<i>Tax (Rind)</i>	(8,780)	(13,508)	(13,508)	(9,668)
<i>Net FV Out</i>	197,252	224,042	224,042	217,198

The amount of the built-in gain is not the only consideration; the decision is also a function of the projected holding period. If the HWB holds the assets inside the corporation, appreciation remains subject to corporate-level and individual-level tax. Once this appreciation becomes large enough, this two-tiered system of taxation negates the benefit of having avoided the initial gain recognition that would have occurred upon liquidation. A comparison of Figure 2E with Figure 5A demonstrates this principle.³⁰⁷

307. In Figure 2E, the built-in gain is \$190,000, and the projected holding period is five years; the asset hold option is economically superior to the liquidation options by \$1,017, the difference between \$203,795 and \$202,778. In Figure 5A, the built-in gain is again \$190,000, but the projected holding period is eleven years; the liquidation options are economically superior to the asset hold option by \$63, the difference between \$343,782 and \$343,719.

Figure 5A
 $ra = 10\%$; $rm = 10\%$; $n = 11$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	200,000	200,000	200,000	200,000
<i>AB In</i>	(10,000)	(10,000)	(10,000)	(10,000)
<i>Gain In</i>	190,000	190,000	190,000	--
<i>Tax (Rco)</i>	(66,500)	(66,500)	(66,500)	--
<i>Net CV In</i>	133,500	133,500	133,500	200,000
<i>AB Out</i>	(133,500)	(133,500)	(133,500)	(169,835)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	133,500	133,500	--
<i>FV</i>	380,891	380,891	380,891	570,623
<i>AB In</i>	(133,500)	--	--	(10,000)
<i>Gain In</i>	247,391	--	--	560,623
<i>Tax (Rco)</i>	(86,587)	--	--	(196,218)
<i>Net FV In</i>	294,304	--	--	374,405
<i>AB Out</i>	(133,500)	(133,500)	(133,500)	(169,835)
<i>Gain Out</i>	160,804	247,391	247,391	204,570
<i>Tax (Rind)</i>	(24,121)	(37,109)	(37,109)	(30,686)
<i>Net FV Out</i>	270,183	343,782	343,782	343,719

As in Figure 4A, where liquidation is preferred and the asset appreciation rate equals the market appreciation rate, the HWB will be indifferent as to cash liquidation and in-kind liquidation.³⁰⁸ However, where the market appreciation rate exceeds the asset appreciation rate, the HWB will prefer cash liquidation so that the HWB can reinvest at the higher market appreciation rate. Figure 6A demonstrates this comparison.³⁰⁹ Conversely, where the asset appreciation rate exceeds

308. The net future cash value under the cash liquidation option equals \$224,042. The net future cash value under the in-kind liquidation option also equals \$224,042. The HWB would be indifferent between the two options.

309. The cash liquidation option is economically superior to the in-kind liquidation option by \$50,257, the difference between \$274,299 and \$224,042.

the market appreciation rate, the HWB would prefer in-kind liquidation because of the higher rate at which the assets appreciate.³¹⁰

Figure 6A

 $ra = 10\%; rm = 15\%; n = 5$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	200,000	200,000	200,000	200,000
<i>AB In</i>	(50,000)	(50,000)	(50,000)	(50,000)
<i>Gain In</i>	150,000	150,000	150,000	--
<i>Tax (Rco)</i>	(52,500)	(52,500)	(52,500)	--
<i>Net CV In</i>	147,500	147,500	147,500	200,000
<i>AB Out</i>	(147,500)	(147,500)	(147,500)	(162,415)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	147,500	147,500	--
<i>FV</i>	296,675	296,675	237,550	322,102
<i>AB In</i>	(147,500)	--	--	(50,000)
<i>Gain In</i>	149,175	--	--	272,102
<i>Tax (Rco)</i>	(52,211)	--	--	(95,236)
<i>Net FV In</i>	244,464	--	--	226,866
<i>AB Out</i>	(147,500)	(147,500)	(147,500)	(162,415)
<i>Gain Out</i>	96,964	149,175	90,050	64,451
<i>Tax (Rind)</i>	(14,545)	(22,376)	(13,508)	(9,668)
<i>Net FV Out</i>	229,919	274,299	224,042	217,198

The principles demonstrated above are by no means novel economic analysis. They represent simple tax-rate arbitrage with varying rates of return. The significance, however, is to expose the flawed assumption in *Estate of Dunn* and *Estate of Jelke*. Assuming that a hypothetical liquidation always occurs on the valuation date misapplies previously well-settled law. A fundamental characteristic about the hypothetical parties is that they seek to maximize their own economic advantage. This principle yields the judicial maxim that courts must not

310. For example, if the market appreciation rate and the asset appreciation rate in Figure 6A were reversed, the net future cash values of the cash liquidation option and the in-kind liquidation option would simply be reversed as well. The in-kind liquidation option would be economically superior to the cash liquidation option by \$50,257, the difference between \$274,299 and \$224,042.

assume the hypothetical parties engage in transactions contrary to wealth maximization.³¹¹ If courts are to uphold this maxim, then they should not assume when determining the built-in gain discount that as a matter of law a HWB liquidates. As Figure 2E and Figure 3A demonstrate, there are indeed situations where holding the asset inside the corporation produces a superior economic result compared to liquidating. In fact, conventional wisdom regarding corporate acquisitions suggests the norm would be holding the assets rather than liquidating.³¹²

Furthermore, holding as a matter of law that a HWB liquidates misconstrues a fundamental principle of net asset valuation. The net asset value approach assumes that the HWB purchases the stock to obtain ownership of the underlying assets; but as courts have stated, this does not mean the only benefit of those assets is conversion into cash.³¹³ As a matter of law, this principle is sound. As a matter of economics, when the asset appreciation rate exceeds the market appreciation rate, this principle is undeniable.

Applying this test to the facts presented in *Estate of Jameson*, *Estate of Dunn*, and *Estate of Jelke*, it is evident that whether a HWB would liquidate can be determined from facts courts regularly gather. The values found in the respective cases demonstrate how the courts could have calculated the built-in gain under a modified liquidation test, as demonstrated in Figure 7, Figure 8, and Figure 9.

311. See *supra* note 33 and accompanying text.

312. See Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 197 (1989).

313. See *supra* note 70 and accompanying text. For this reason, in *Estate of Dunn* the Fifth Circuit erred in ruling that a HWB would immediately convert the assets to cash. See 301 F.3d 339, 353 (5th Cir. 2002).

Figure 7 (*Estate of Jameson*)³¹⁴ $ra = 14\%$; $rm = 20\%$; $n = 4.5$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	6,000,000	6,000,000	6,000,000	6,000,000
<i>AB In</i>	(217,850)	(217,850)	(217,850)	(217,850)
<i>Gain In</i>	5,782,150	5,782,150	5,782,150	--
<i>Tax (Rco)</i>	(2,023,753)	(2,023,753)	(2,023,753)	--
<i>Net CV In</i>	3,976,247	3,976,247	3,976,247	6,000,000
<i>AB Out</i>	(3,976,247)	(3,976,247)	(3,976,247)	(4,670,469)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	3,976,247	3,976,247	--
<i>FV</i>	9,032,106	9,032,106	7,170,431	10,819,896
<i>AB In</i>	(3,976,247)	--	--	(217,850)
<i>Gain In</i>	5,055,859	--	--	10,602,046
<i>Tax (Rco)</i>	(1,769,551)	--	--	(3,710,716)
<i>Net FV In</i>	7,262,555	--	--	7,109,180
<i>AB Out</i>	(3,976,247)	(3,976,247)	(3,976,247)	(4,670,469)
<i>Gain Out</i>	3,286,308	5,055,859	3,194,184	2,438,711
<i>Tax (Rind)</i>	(492,946)	(758,379)	(479,128)	(365,807)
<i>Net FV Out</i>	6,769,609	8,273,727	6,691,303	6,743,373

314. The values in Figure 7 are calculated using the factual findings in *Estate of Jameson v. Comm'r*, 267 F.3d 366 (5th Cir. 2001). In *Estate of Jameson*, the current value of the assets was \$6,000,000. *Id.* at 368. The corporation's basis in those assets was \$217,850. *Id.* The asset appreciation rate was fourteen percent, and the market appreciation rate was twenty percent. *See id.* at 372. The Tax Court used a nine-year turn-over rate, meaning that all of the corporation's current assets would be sold over nine years. *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383, 1397 (5th Cir. 2001). Rather than calculating nine blocks to account for each year's turn-over, *see infra* text § IV.D, Figure 7 uses a projected holding period of four and one-half years as the mean of the projected holding periods.

Figure 8 (*Estate of Dunn*)³¹⁵
 $ra = 6\%$; $rm = 8\%$; $n = 5$

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	7,519,439	7,519,439	7,519,439	7,519,439
<i>AB In</i>	(410,439)	(410,439)	(410,439)	(410,439)
<i>Gain In</i>	7,109,000	7,109,000	7,109,000	--
<i>Tax (Rco)</i>	(2,488,150)	(2,488,150)	(2,488,150)	--
<i>Net CV In</i>	5,031,289	5,031,289	5,031,289	7,519,439
<i>AB Out</i>	(5,031,289)	(5,031,289)	(5,031,289)	(5,479,715)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	5,031,289	5,031,289	--
<i>FV</i>	7,392,614	7,392,614	6,733,000	10,062,706
<i>AB In</i>	(5,031,289)	--	--	(410,439)
<i>Gain In</i>	2,361,325	--	--	9,652,267
<i>Tax (Rco)</i>	(826,464)	--	--	(3,378,293)
<i>Net FV In</i>	6,566,150	--	--	6,684,413
<i>AB Out</i>	(5,031,289)	(5,031,289)	(5,031,289)	(5,479,715)
<i>Gain Out</i>	1,534,861	2,361,325	1,701,711	1,204,698
<i>Tax (Rind)</i>	(230,229)	(354,199)	(255,257)	(180,705)
<i>Net FV Out</i>	6,335,921	7,038,415	6,477,743	6,503,708

315. The values in Figure 8 are calculated using the factual findings in *Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, 1344 (2000). In *Estate of Dunn*, the current value of the assets was \$7,519,439. *Id.* at 1344. The corporation's built-in gain in those assets was \$7,109,000. *Id.* Therefore, the corporation's basis in the assets was the difference between the current value and built-in gain, which equaled \$410,439. Expert testimony provided that the asset appreciation rate was lower than the rate of return for low-risk government-backed investments. *Id.* at 1340. At the decedent's death on June 8, 1991, the five-year Treasury rate was approximately eight percent. *See id.* at 1337; *See* U.S. Dep't of Treasury, *Daily Treasury Yield Curve Rates*, http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_1991.shtml (last visited September 19, 2008). This amount has been used as the market appreciation rate. Given the expert testimony that the asset appreciation rate was lower than the market appreciation rate, Figure 8 assumes an asset appreciation rate of six percent. *See Estate of Dunn*, 79 T.C.M. (CCH) at 1340. No turn-over rate or projected holding period was determined. Figure 8 assumes a five-year projected holding period.

Figure 9 (*Estate of Jelke*)³¹⁶
 $ra = 23\%$; $rm = 13\%$; $n = 5$
 (values in hundreds)

	Asset Sale	Cash. Liq.	In-Kind Liq.	Asset Hold
<i>CV</i>	1,886,358	1,886,358	1,886,358	1,886,358
<i>AB In</i>	(411,305)	(411,305)	(411,305)	(411,305)
<i>Gain In</i>	1,475,053	1,475,053	1,475,053	--
<i>Tax (Rco)</i>	(516,269)	(516,269)	(516,269)	--
<i>Net CV In</i>	1,370,089	1,370,089	1,370,089	1,886,358
<i>AB Out</i>	(1,370,089)	(1,370,089)	(1,370,089)	(1,748,881)
<i>Gain Out</i>	--	0	0	--
<i>Tax (Rind)</i>	--	(0)	(0)	--
<i>Net CV Out</i>	--	1,370,089	1,370,089	--
<i>FV</i>	3,642,306	3,642,306	7,177,775	9,882,460
<i>AB In</i>	(1,370,089)	--	--	(411,305)
<i>Gain In</i>	2,272,217	--	--	9,471,155
<i>Tax (Rco)</i>	(795,276)	--	--	(3,314,904)
<i>Net FV In</i>	2,847,030	--	--	6,567,556
<i>AB Out</i>	(1,370,089)	(1,370,089)	(1,370,089)	(1,748,881)
<i>Gain Out</i>	1,476,941	2,272,217	5,807,686	4,818,675
<i>Tax (Rind)</i>	(221,541)	(340,833)	(871,153)	(722,801)
<i>Net FV Out</i>	2,625,489	3,301,473	6,306,622	5,844,755

Two points about these figures are worth noting. First, the Fifth Circuit in *Estate of Jameson* properly considered the difference between the asset appreciation rate and the market appreciation rate. Even though the corporation had a large built-in gain, the market appreciation

316. The values in Figure 9 are calculated using the factual findings in *Estate of Jelke v. Comm'r*, 89 T.C.M. (CCH) 1397 (2005). In *Estate of Jelke*, the current value of the assets was \$188,635,833. *Id.* at 1399. These assets had a built-in tax liability of \$51,626,884. *Id.* Assuming a thirty-five percent corporate tax rate, the built-in gain would have been \$147,505,383, and the corporation's basis would have been \$41,130,450. The asset appreciation rate was approximately twenty-three percent. *See id.* The market appreciation rate was thirteen percent. *See id.* at 1402. The Tax Court used a sixteen-year turn-over rate, meaning that all of the corporation's current assets would be sold over sixteen years. *Id.* Rather than calculating sixteen blocks to account for each year's turn-over, *see infra* text § IV.D, Figure 9 uses a projected holding period of eight years as the mean of the projected holding periods.

rate was significantly higher than the asset appreciation rate, resulting in corporate liquidation being the superior option. However, had the rates been equal, a HWB would have held the assets to avoid immediate recognition of the built-in gain, and the dollar-for-dollar discount would have been inappropriate.³¹⁷ The same would have been true in *Estate of Dunn*.³¹⁸

Second, despite *Estate of Dunn* and *Estate of Jelke* problematically holding that the dollar-for-dollar discount should be applied as a matter of law, the values demonstrate the Fifth Circuit and the Eleventh Circuit actually held correctly. Given the amount of the built-in gain, a HWB of the corporations in *Estate of Dunn* and *Estate of Jelke* would have liquidated because the benefit of avoiding two-tiered taxation on future appreciation would have outweighed the detriment of immediately recognizing the built-in gain. Therefore, the dollar-for-dollar discount was appropriate, as gain would have been recognized immediately. The fact that the Fifth Circuit and the Eleventh Circuit reached the right result for the wrong reason arguably supports the idea that judicial efficiency should prevail. However, cases where liquidation is preferred may very well be anomalies.³¹⁹ Courts should instead implement a modified liquidation test as a more accurate yet efficient method of adjudication.

C. Calculating the Built-in Gain Discount

The IRS has argued and the Tax Court has seemingly agreed that the built-in gain discount should be calculated by treating the potential tax as a liability under the net asset value approach.³²⁰ Under this method, the first step is to calculate as of the valuation date the built-in gain in the underlying assets and the tax that would be imposed on that gain if the gain were recognized immediately. Based upon the projected holding period, the liability is discounted to present value and is

317. As evident from Figure 7, cash liquidation where the market appreciation rate equals twenty percent would yield net future cash value of \$8,273,727. If the asset appreciation rate also would have been twenty percent, the net future cash value of an asset hold would have been \$8,328,682. Therefore, the HWB would have held the assets in the corporation if the rates had been equal.

318. If the asset appreciation rate had also been eight percent, the net future cash value of an asset hold would have been \$7,068,345, which is superior to \$7,038,415.

319. See *supra* note 312.

320. See *Estate of Jelke*, 89 T.C.M. (CCH) at 1404; *Estate of Dunn*, 79 T.C.M. (CCH) at 1345; *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383, 1396-97 (5th Cir. 2001).; but see *infra* note 323 and accompanying text.

subtracted from the value of the assets to yield a net asset value. This liability approach is problematic because it ignores the type of economic analysis the HWB would likely undertake. Simply freezing the built-in gain on the valuation date and discounting it to present value overlooks the impact the built-in gain will have on the HWB's net future cash value. The built-in gain and the related tax liability are not static; instead, as the value of the underlying assets increases, so does the built-in gain. In response to this challenge, the IRS has argued that considering future appreciation permits a discount for future taxes.³²¹

At first glance, the IRS's argument seems to have some merit; however, a closer look reveals the flaws. Because the HWB seeks to maximize economic advantage, the treatment of the tax on the built-in gain as a liability frames the question in an unrealistic light. The HWB's concern is not calculating actual future tax liability. Rather, the HWB seeks to maximize net future cash value. The relevant question is to what extent the built-in gain impedes the realization of future wealth. Thus, the HWB must determine what amount of money invested in an identical corporation without a built-in gain would yield the same net future cash value as the purchase of stock in the corporation with the built-in gain. For this same reason, while future appreciation is a relevant consideration, using future appreciation to determine future gain recognition and discounting such gain to present value fails to provide an accurate measure of the appropriate discount.³²²

Further, the built-in gain discount should not be viewed as a liability in computing net asset value. Instead, the discount is better understood as a subsidiary component of a lack of marketability discount. Stock in a corporation with built-in gains is worth less because it is unmarketable on account of the fact that the HWB could pay less for stock in an identical corporation without a built-in gain and still receive the same net future cash value. A few decisions have recognized such.³²³

To properly calculate the discount, the HWB will select whichever of the four options yields the highest net future cash value. Using the superior option, the HWB can calculate the amount of the discount by

321. See *Estate of Jelke*, 89 T.C.M. (CCH) at 1403-04. The Tax Court agreed. *Id.* at 1404.

322. Such a calculation may fail to yield an accurate result as it does not account for the HWB's incentive to liquidate or to hold. Further, it simply discounts the future liability rather than considering net future cash value. The decision in *Estate of Litchfield v. Commissioner* seems to overlook these considerations. 97 T.C.M. (CCH) 1079 (2009).

323. See *Estate of Davis v. Comm'r*, 110 T.C. 530, 553-54 (1998); *Gallun v. Comm'r*, 33 T.C.M. 1316, 1321 (1974).

comparing the net future cash value of the superior option to the net future cash value of a hypothetical option in which an identical corporation has no built-in gain. The discount is the excess of the net future cash value of the hypothetical option over the net future cash value of the superior option, represented as a percentage of net future cash value of the hypothetical option.³²⁴ Figure 3B demonstrates this point.

Given the values in Figure 3A, it was clear the HWB had an incentive to retain the assets in the corporation. By holding for five years assets with current value of \$200,000 and a basis of \$5,000, the HWB would have a net future cash value of \$202,119. However, if \$200,000 in assets had a \$200,000 basis so that the corporation had no built-in gain, then the HWB would have received \$267,461. The difference in the net future cash values is the direct result of the built-in gain. Because of the built-in gain, the HWB receives 24.43 percent less than the HWB would have received investing the same amount of money in an identical corporation without a built-in gain. Instead, if the HWB were to invest 24.43 percent less, \$151,140, in an identical corporation without a built-in gain, the HWB would receive the same net future cash value as the HWB would have received had the HWB invested in the actual corporation. The marketability of the actual corporation is impaired by 24.43 percent on account of the built-in gain, as the HWB would pay only \$151,140 to receive net future cash value of \$202,119.

324. This computation can again be performed algebraically. The relevant formulae are as follows:

Generally:

$$d = 1 - \frac{\text{NetFV Out with BIG}}{\text{NetFV Out without BIG}}$$

Where an asset sale, cash liquidation, or in-kind liquidation is preferred:

$$d = 1 - \frac{CV(1 - Rco) + RcoABIn}{CV(1 - Rco) + RcoCV}$$

Where an asset hold is preferred:

$$d = 1 - \frac{CV(1 - Rco)(1 + ra)^n + RcoABIn}{CV(1 - Rco)(1 + ra)^n + RcoCV}$$

Figure 3B

 $ra = 10\%$; $rm = 10\%$; $n = 5$

	Hold w/ BIG	Hold w/o BIG	DCV w/o BIG
<i>CV</i>	200,000	200,000	151,139
<i>AB In</i>	(5,000)	(200,000)	(151,139)
<i>Gain In</i>	--	--	--
<i>Tax (Rco)</i>	--	--	--
<i>Net CV In</i>	200,000	200,000	151,139
<i>AB Out</i>	(151,139)	(200,000)	(151,139)
<i>Gain Out</i>	--	--	--
<i>Tax (Rind)</i>	--	--	--
<i>Net CV Out</i>	--	--	--
<i>FV</i>	322,102	322,102	322,102
<i>AB In</i>	(5,000)	(200,000)	(5,000)
<i>Gain In</i>	317,102	122,102	317,102
<i>Tax (Rco)</i>	(110,986)	(42,736)	(110,986)
<i>Net FV In</i>	211,116	279,366	211,116
<i>AB Out</i>	(151,139)	(200,000)	(151,139)
<i>Gain Out</i>	59,977	79,366	59,977
<i>Tax (Rind)</i>	(8,997)	(11,905)	(8,997)
<i>Net FV Out</i>	202,119	267,461	202,119

 $d = 24.43\%$

DCV = 151,139

Only where the relevant values indicate that liquidation would yield the highest net future cash value would the dollar-for-dollar discount result. Figure 4B shows the application of this analysis to the values from Figure 4A. Figure 4B confirms that the dollar-for-dollar discount is appropriate as \$52,500, the amount of tax that would be payable upon liquidation, divided by \$200,000, the current value of the assets, also equals 26.25 percent.

Figure 4B

 $ra = 10\%$; $rm = 10\%$; $n = 5$

	Liquidation w/ BIG	Liquidation w/o BIG	DCV w/o BIG
<i>CV</i>	200,000	200,000	147,500
<i>AB In</i>	(50,000)	(200,000)	(147,500)
<i>Gain In</i>	150,000	0	0
<i>Tax (Rco)</i>	(52,500)	(0)	(0)
<i>Net CV In</i>	147,500	200,000	147,500
<i>AB Out</i>	(147,500)	(200,000)	(147,500)
<i>Gain Out</i>	0	0	--
<i>Tax (Rind)</i>	(0)	(0)	--
<i>Net CV Out</i>	147,500	200,000	147,500
<i>FV</i>	237,550	322,102	237,550
<i>AB In</i>	--	--	--
<i>Gain In</i>	--	--	--
<i>Tax (Rco)</i>	--	--	--
<i>Net FV In</i>	--	--	--
<i>AB Out</i>	(147,500)	(200,000)	(147,500)
<i>Gain Out</i>	90,050	122,102	90,050
<i>Tax (Rind)</i>	(13,508)	(18,315)	(13,508)
<i>Net FV Out</i>	224,042	303,787	224,042

 $d = 26.25\%$

DCV = 147,500

D. Further Considerations

The above analysis is by no means perfect, nor does it purport to be applicable to every possible scenario that “life in all its fullness”³²⁵ might supply. Instead, a modified liquidation test mirrors the essence of transfer tax valuation—it seeks to provide a close approximation of an

325. See *Welch v. Helvering*, 290 U.S. 111, 115-16 (1933) (Cardozo, J.) (acknowledging that the complexity of economic transactions may require a case-by-case analysis to determine appropriate tax treatment).

economic reality that can rarely be reduced to exactitude.³²⁶ Accordingly, some further considerations are worth noting.

Most importantly, for the above calculations to function properly the asset appreciation rate and the projected holding period must be the same for all assets analyzed in each equation. Accordingly, implicit in the above analysis is the assumption that there is either a single asset in the corporation or that multiple assets in the corporation bear the same asset appreciation rate and projected holding period. As these figures demonstrate how the modified liquidation test could be applied to a relatively simple set of facts, it remains necessary to account for the possibility of more complicated factual scenarios and the challenges that such scenarios present for determining the discount, including the proper computation of the discount and the implications for corporate tax treatment.

More complicated factual scenarios might arise in two situations. First, it is possible that the corporation will hold several of the same asset, for example, multiple shares of the same marketable security. The HWB may choose to segregate the shares into multiple blocks and select a different projected holding period for each block. Second, it is almost certain that the corporation will hold multiple assets. If the corporation holds multiple assets, it is likely that the assets will have different asset appreciation rates and different projected holding periods.

In such scenarios, the application of the modified liquidation test becomes more complicated, though the fundamental principles and assumptions remain valid. To accurately compute the built-in gain discount, it is necessary to segregate the blocks or assets into groups with the same projected holding period and same asset appreciation rate. Then, using the methodology applied above, the discount for each block or asset can be computed. Finally, a built-in gain discount for the entire corporation can be computed by using the current value of each block or asset to calculate the weighted average of the respective discounts.

The computation of the built-in gain discount where multiple projected holding periods or multiple asset appreciation rates are involved may raise doubts about the fundamental assumption that distributions from the corporation receive sale or exchange treatment. However, this remains an accurate assumption. The problem posed by the presence of multiple projected holding periods or multiple asset

326. See *Estate of Thalheimer v. Comm'r*, 33 T.C.M. (CCH) 877, 910 (1974) (stating that as "valuation is not an exact science, no formula can be devised that will be generally applicable to all cases").

appreciation rates is the possibility that the HWB would have the incentive to liquidate some blocks or assets, either in cash or in kind, and to hold other blocks or assets. For example, if the corporation owned two blocks of the same asset described in Figure 2E and had a projected holding period of five years for one block and of eleven years for the other block, it may seem the HWB would hold the five-year block and distribute the eleven-year block.³²⁷ Similarly, if the corporation owned the assets described in Figure 2E and the assets described in Figure 6A, it may seem the HWB would hold the Figure 2E assets and distribute the cash sale proceeds of the Figure 6A assets.

At first glance, this would appear to mean that sale or exchange treatment would be unavailable for the distributions. The above analysis assumed that any distribution from the corporation to the HWB will be a liquidating distribution, meaning that either the HWB liquidates all the HWB's stock or the corporation liquidates all its underlying assets. If the HWB liquidates all the HWB's stock, the distribution is one in complete redemption of the HWB's interest, resulting in sale or exchange treatment under § 302(b)(3). If the liquidation is in complete liquidation of the corporation, the distribution receives sale or exchange treatment under § 331. This treatment is always proper where there is a single asset. It is also appropriate where there are multiple assets that the HWB plans to hold for the same projected holding period. In these circumstances, there would be only one distribution, either immediately upon purchase or at the end of the projected holding period, and either § 302(b)(3) or § 331 would apply.

However, where the HWB has an incentive to distribute some blocks or assets and to hold other blocks or assets, then neither § 302(b)(3) nor § 331 would apply.³²⁸ Nonetheless, the assumption that the distributions will receive sale or exchange treatment remains valid. The consequence of failing to receive sale or exchange treatment would be such that it would *alter the incentive* to make multiple distributions. The figures suggest that the HWB will either hold entirely or liquidate entirely, thereby ensuring sale or exchange treatment under either § 302(b)(3) or § 331.

327. Compare *supra* Figure 2E, with *supra* Figure 5A.

328. Because the distribution would not be in complete redemption of the HWB's stock, I.R.C. § 302(b)(3) would not apply. Because the corporation would not be in complete liquidation, I.R.C. § 331 would not apply. There may be some possibility that the distributions would receive sale or exchange treatment under I.R.C. § 302(b)(2) or (b)(4), but such a possibility would be highly fact dependent and impossible to generalize.

First, the incentives may shift if the corporation owns two blocks of the same asset and projects two different holding periods. For example if the corporation owns a Figure 2E block and a Figure 5A block, the HWB would no longer have the incentive to liquidate the Figure 5A block; instead, the HWB would hold both blocks. This is because if the HWB were to immediately distribute the Figure 5A block, the distribution would be subject to § 301.³²⁹ If the corporation has sufficient earnings and profits, which is likely the case, the net future cash value of the Figure 5A block would be represented as in Figure 5B. In contrast to the above calculations, which demonstrated the tax consequences with a return of capital, Figure 5B shows the result where the initial distribution is entirely subject to tax as a dividend.

Thus, if dividend treatment applies to the first distribution, the Figure 5A block, then the HWB will have a net future cash value of \$292,215 for the Figure 5A block. Sale or exchange treatment will apply to the Figure 2E block,³³⁰ which will have a net future cash value of \$203,795.³³¹ Accordingly, distributing the Figure 5A block and holding the Figure 2E block will result in a total net future cash value of \$496,010.³³² In such a scenario, holding both blocks or liquidating both blocks would be superior. By holding both, the HWB would have a net future cash value of \$547,514.³³³ By liquidating both, the HWB would have a net future cash value of \$546,560.³³⁴ Therefore, the HWB will hold both assets to avoid dividend treatment. The total built-in gain discount would be the weighted average of the discounts for each block.

329. I.R.C. § 301. *See supra* text § IV.A.

330. The distribution would be made in complete redemption of the HWB's stock and would therefore be subject to I.R.C. § 302(b)(3).

331. *See supra* Figure 2E.

332. Calculated as \$203,795, the net future cash value of the Figure 2E block under an asset hold option if sale or exchange treatment applies, plus \$292,215, the net future cash value of the Figure 5A block if dividend treatment applies. *See supra* Figure 2E. *See infra* Figure 5B.

333. Calculated as \$203,795, the net future cash value of the Figure 2E block under an asset hold option if sale or exchange treatment applies, plus \$343,719, the net future cash value of the Figure 5A block under an asset hold option if sale or exchange treatment applies. *See supra* Figure 2E. *See supra* Figure 5A.

334. Calculated as \$202,778, the net future cash value of the Figure 2E block under a liquidation option if sale or exchange treatment applies, plus \$343,782, the net future cash value of the Figure 5A block under a liquidation option if sale or exchange treatment applies. *See supra* Figure 2E. *See supra* Figure 5A.

Figure 5B

 $ra = 10\%$; $rm = 10\%$; $n = 5$

	Dist.
<i>CV</i>	200,000
<i>AB In</i>	<u>(10,000)</u>
<i>Gain In</i>	190,000
<i>Tax (Rco)</i>	<u>(66,500)</u>
<i>Net CV In</i>	133,500
<i>Tax (Rind)</i>	<u>20,025</u>
<i>Net CV Out</i>	113,475
<i>FV</i>	323,757
<i>AB In</i>	<u>--</u>
<i>Gain In</i>	--
<i>Tax (Rco)</i>	<u>--</u>
<i>Net FV In</i>	--
<i>AB Out</i>	<u>(113,475)</u>
<i>Gain Out</i>	210,282
<i>Tax (Rind)</i>	<u>(31,542)</u>
<i>Net FV Out</i>	292,215

Figure 6B

 $ra = 10\%$; $rm = 15\%$; $n = 5$

	Cash Dist.
<i>CV</i>	200,000
<i>AB In</i>	<u>(50,000)</u>
<i>Gain In</i>	150,000
<i>Tax (Rco)</i>	<u>(52,500)</u>
<i>Net CV In</i>	147,500
<i>Tax (Rind)</i>	<u>22,125</u>
<i>Net CV Out</i>	125,375
<i>FV</i>	252,174
<i>AB In</i>	<u>--</u>
<i>Gain In</i>	--
<i>Tax (Rco)</i>	<u>--</u>
<i>Net FV In</i>	--
<i>AB Out</i>	<u>(125,375)</u>
<i>Gain Out</i>	126,799
<i>Tax (Rind)</i>	<u>(19,020)</u>
<i>Net FV Out</i>	233,154

A similar result may arise if the corporation owns the Figure 2E assets and the Figure 6A assets, as the HWB will no longer have the incentive to hold the Figure 2E assets. If the HWB were to immediately distribute the cash sale proceeds of the Figure 6A assets, the distribution would be subject to § 301. If the corporation has sufficient earnings and profits, the net future cash value of the Figure 6A assets would be represented by Figure 6B, which shows the result where the initial distribution is entirely subject to tax as a dividend.

Thus, if dividend treatment applies to the first distribution, the Figure 6A assets, then the HWB will have a net future cash value of \$233,154 for the Figure 6A assets. Sale or exchange treatment will apply to the Figure 2E assets,³³⁵ which will have a net future cash value of \$203,795.³³⁶ Accordingly, holding the Figure 2E assets and distributing the Figure 6A assets will result in a total net future cash

335. The distribution would be made in complete redemption of the HWB's stock and would therefore be subject to I.R.C. § 302(b)(3).

336. See *supra* Figure 2E.

value of \$436,949.³³⁷ In such a scenario, liquidating both assets would be superior. By liquidating both, the HWB would have a net future cash value of \$477,077.³³⁸ Therefore, the HWB will choose to liquidate both assets to avoid dividend treatment. A dollar-for-dollar discount would be appropriate.

Two final considerations are worth noting. First, the above analysis assumes that where liquidation is most advantageous, such liquidation will occur. This assumption is made for analytical purposes only, and it does not necessarily reflect what would necessarily occur. In some circumstances, the HWB will control insufficient voting power to effectuate liquidation of corporate assets or the redemption of stock. The HWB, despite being able to calculate the most advantageous course of action, will be unable to realize the maximum possible wealth. Nonetheless, such scenarios ought to have no impact on the calculation of the built-in gain discount. In these circumstances, it is not the built-in gain that impedes the realization of future wealth. Instead, it is the HWB's inability to control the corporation that renders the interest worth less. Transfer tax valuation jurisprudence already has a mechanism to account for such circumstances—the lack of control discount.³³⁹ Thus, to factor into the built-in gain discount the HWB's minority control would be inaccurate and redundant.

Second, a possible argument exists that the entire premise of a modified liquidation test is flawed in that rather than using the net asset value approach to account for the built-in gain, a market approach would be more appropriate. Certainly where the market approach is available, it is an easier methodology to apply. Therefore, there may be circumstances where closed-end mutual funds, whose value would already reflect a discount for built-in tax liability, might be used as comparable property under a market approach. However, where the differences between the comparable property and the entity being valued are too great to be remedied by adjustment, use of the market approach

337. Calculated as \$203,795, the net future cash value of the Figure 2E assets under an asset hold option if sale or exchange treatment applies, plus \$233,154, the net future cash value of the Figure 6A assets if dividend treatment applies. *See supra* Figure 2E. *See supra* Figure 6B.

338. Calculated as \$202,778, the net future cash value of the Figure 2E assets under a liquidation option if sale or exchange treatment applies, plus \$274,299, the net future cash value of the Figure 6A assets under a cash liquidation option if sale or exchange treatment applies. *See supra* Figure 2E. *See supra* Figure 6A.

339. *Supra* notes 76-82 and accompanying text. The Tax Court has apparently overlooked this point. *See Estate of Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, 1344-45 (2000), *rev'd*, 301 F.3d 339 (5th Cir. 2002).

would be inappropriate.³⁴⁰ Courts that have considered using closed-end mutual funds as comparable property have found the disparities between the funds and the entities being valued too significant, and they have declined the use of the market approach.³⁴¹ Future courts would likely do the same.

IV. CONCLUSION

Resolution of the debate over the built-in gain discount will have significant implications for transfer taxation. Despite the Fifth Circuit and the Eleventh Circuit offering bright-line tests permitting the dollar-for-dollar discount, proper calculation of the discount is far from settled. Particularly in light of the Supreme Court's unwillingness to offer a resolution, adoption of an accurate yet reasonably straightforward test will be critical to ensure fair adjudication of the issue. A modified liquidation test provides such a resolution. By embracing the logical and historical significance of the prospective liquidation test, a modified liquidation test addresses the impact of the repeal of the *General Utilities* doctrine. Moreover, by reducing complex computations to usable formulae, it offers a method for courts to produce accurate decisions without excessively expending judicial resources.

But whether a modified liquidation test may ever make its way into jurisprudence on the built-in gain discount is questionable, as taxpayers and the IRS are unlikely to yield from their current arguments. Taxpayers will continue to assert entitlement to the taxpayer-friendly dollar-for-dollar discount; the IRS will seek to minimize the discount by freezing the built-in gain on the valuation date and discounting its recognition to present value. Thus, courts may be left to a "life of toil and effort" to determine for themselves the just and accurate decision.

340. See *supra* note 63 and accompanying text.

341. See *Estate of Jephson v. Comm'r*, 87 T.C. 297, 304 (1986) (citing *Estate of Piper v. Comm'r*, 72 T.C. 1062 (1979)); *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982); *Obermer v. United States*, 238 F. Supp. 29, 34-35 (D. Haw. 1964).

