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Tax Valuation E-Flash

Beatrice Ellen Jones Dunn v. Commissioner, U.S. Court of Appeals for the 5th Circuit, No. 00-60614, August 1, 2002

In an opinion sharply critical of both the IRS and the Tax Court, the Fifth Circuit reversed and remanded [Estate of Beatrice Dunn v. Commissioner](#), T.C. Memo 2000-12, January 12, 2000. The Fifth Circuit determined that 100% of the tax on the trapped-in taxable gain for a C corporation must be subtracted under the asset approach. The Tax Court had used only a 5% tax rate in their calculation rather than the actual 34% rate. The 65% weighting assigned to the asset approach by the Tax Court was reduced to 15%, increasing the weight assigned to the income approach from 35% to 85%.

Decedent died in 1991, owning 62.96% of Dunn Equipment, a C corporation that owned and operated heavy equipment and provided related services, primarily in the petroleum industry. The Tax Court valued Dunn Equipment by assigning only a 35% weight to the value determined

"...the Commissioner merely engaged in guerilla warfare, presenting only an accounting expert to snipe at the methodology of the Estate's valuation expert."

using the income approach, a value which was lower than that resulting from the use of the asset approach. The remaining 65% of value was determined under the asset approach, including a reduction for only 5% of the trapped-in taxable gain based on the probability of liquidation of the assets. The 15% discount for lack of marketability and a 7.5% discount for lack of super-majority allowed by the Tax Court were not appealed.

In Tax Court, the IRS argued that no discount should be allowed for the trapped-in gains and no weight should be assigned to the lower income approach value. The Fifth Circuit said,

Yet, instead of supporting his own higher values (for which he had the burden of proof) by proffering professional expert valuation testimony during the trial, the Commissioner merely engaged in guerilla

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warfare, presenting only an accounting expert to snipe at the methodology of the Estate's valuation expert. The use of such trial tactics might be legitimate when merely contesting values proposed by the party opposite, but they can never suffice as support for a higher value affirmatively asserted by the party employing such a trial strategy. This is particularly true when, as here, that party is the Commissioner, who has the burden of proving the expanded value asserted in his amended answer. . .

Consequently, the Commissioner's insistence at trial that the value of the subject stock in Dunn Equipment be determined exclusively on the basis of the market value of its assets, undiminished by their inherent tax liability -- coupled with his failure to adduce affirmative testimony of a valuation expert -- was so

"We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets."

incongruous as to call his motivation into question. It can only be seen as one aimed at achieving maximum revenue at any cost, here seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement -- or, failing that, then a compromise judgment -- somewhere between the value returned by the taxpayer (which, by virtue of the Commissioner's eleventh-hour deficiency notice, could not effectively be revised downward) and the unsupportedly excessive value eventually proposed by the Commissioner. And, that is precisely the result that the Commissioner obtained in the Tax Court.

The Tax Court accepted a 34% tax rate on the trapped-in gain, but followed the IRS "no imminent liquidation" argument, allowing only 5% of the trapped-in gains as a reduction to the net asset value. The Fifth Circuit termed this a "red herring" and said,

We are satisfied that the hypothetical willing buyer of the Decedent's block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true "in spades" when, for purposes of computing the asset-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business's assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of the Corporation, just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation's earnings-based value.

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While criticizing the likelihood of liquidation concept in determining the reduction in value for trapped-in capital gains, the Fifth Circuit said this concept does play a key role in assigning relative weights to the income and asset approaches. The lesser the likelihood of liquidation, the greater the weight that must be assigned to the income approach. The Fifth Circuit called the Tax Court's assignment of a 35% weight to the income approach a "legal, logical, and economic non sequitur." The Fifth Circuit determined that 85% of the final value should be determined using the income approach.

In its conclusion, the Fifth Circuit cited the IRS Commissioner's "extreme and unjustifiable trial position in advocating a valuation based entirely on asset value (with no reduction for built-in tax liability and no weight given to income-based value), exacerbated by his failure to adduce expert appraisal testimony in support of his own exorbitant proposed value" and told the Tax Court to entertain any claim that the taxpayer might make under I.R.C. §7430, which awards certain costs and fees to the taxpayer.