

**OF ROCKS AND HARD PLACES: OPTING FOR ARBITRARINESS OR  
SPECULATION IN THE BUILT-IN CAPITAL GAINS TAX DISCOUNT  
IN THE VALUATION OF CLOSELY HELD BUSINESSES FOR ESTATE  
AND GIFT TAX PURPOSES**

**BRENT B. NICHOLSON\***

**INTRODUCTION**

Since the repeal of the *General Utilities* doctrine<sup>1</sup> in the Tax Reform Act of 1986<sup>2</sup>, an issue has been festering concerning estate and gift tax valuations of closely held stock.<sup>3</sup> The Treasury Regulations (“Regulations”) require that assets be valued at fair market value determined by the price that a hypothetical buyer and seller would agree upon as of the date of death (or date of the gift)<sup>4</sup>. The issue addressed in this article is whether the taxpayer is allowed to discount that fair market value by some or the entire amount of the capital gains tax that would theoretically be payable upon liquidation or distribution of the business’s appreciated assets (often referred to as “built-in gains”).

The Internal Revenue Service (“IRS” or “Service”) and the Tax Court initially determined that such a discount was not permitted because the amount of the tax was too speculative.<sup>5</sup> However, after contrary holdings by the Second, Fifth,

---

\* J.D. 1979, Ohio State University College of Law; B.S.B.A. 1976, Bowling Green State University. Brent B. Nicholson is Chair of the Department of Legal Studies and an Associate Professor of Legal Studies at Bowling Green State University.

<sup>1</sup> The *General Utilities* doctrine, which allowed a corporation to liquidate its assets and pass the proceeds to its shareholders without the corporation being taxed on the gains, originated from *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). See *infra* notes 29-31 and accompanying text.

<sup>2</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

<sup>3</sup> Estate and gift taxes are based on cumulative lifetime transfers and property owned (as defined by the Internal Revenue Code) at the date of death. Graduated rates are applied based on the total amount of estate property and lifetime transfers less exempt transfers and amounts. See I.R.C. §§ 2001, 2502 (2006).

<sup>4</sup> Treas. Reg. § 20.2031-1(b) (as amended in 1965) (estate tax valuation); Treas. Reg. § 25.2512-1 (as amended in 1992) (gift tax valuation).

<sup>5</sup> See, e.g., *Estate of Luton v. Comm’r*, 68 T.C.M. (CCH) 1044 (1994); *Estate of Bennett v. Comm’r*, 65 T.C.M. (CCH) 1816 (1993); *Ward v. Comm’r*, 87 T.C. 78 (1986); *Estate of Andrews v. Comm’r*, 79 T.C. 938 (1982); *Estate of Piper v. Comm’r*, 72 T.C. 1062 (1979); *Estate of Cruikshank v. Comm’r*, 9 T.C. 162 (1947). In a Technical Advice Memorandum, the Service advised that while the *General*

and Sixth Circuits, a discount is now permissible even absent a showing that liquidation is likely.<sup>6</sup> The focus of the courts has largely shifted to the amount of the discount. The Second and Sixth Circuits have not definitively established whether a full discount is allowable, but have hinted that something less than the full amount of the tax is more appropriate.<sup>7</sup> The Fifth and Eleventh Circuits, however, have now held that a full discount is proper.<sup>8</sup> In June 2008, the Commissioner of the IRS petitioned the United States Supreme Court to review the Eleventh Circuit's decision in *Commissioner v. Estate of Jelke*.<sup>9</sup> The Supreme Court denied certiorari on October 6, 2008.<sup>10</sup>

This article will examine the most important decisions leading up to *Jelke*, provide a thorough examination of the *Jelke* appellate court decision, and end with an analysis of what the most appropriate valuation method should be. Many hoped that the Supreme Court would hear the *Jelke* case and resolve the issue so that valuations could be conducted on a more consistent basis across the country.<sup>11</sup> That hope, however, was not realized.

## I. THE STATUTORY AND REGULATORY PROVISIONS

This discussion begins with an examination of the Internal Revenue Code (the "Code"). Under § 2031 of the Code, the federal estate tax encompasses all property of a decedent as valued at time of death, valued as of the time of death.<sup>12</sup>

---

*Utilities* doctrine was one reason for disallowing the tax discount, the primary reason was the "speculative nature of the liquidation itself." The abrogation of *General Utilities* by the Tax Reform Act of 1986 thus had no effect on the disallowance of the discount. No liquidation was contemplated under the facts of the Memorandum, so no discount was allowed. I.R.S. Tech. Adv. Mem. 91-50-001 (Aug. 20, 1991).

<sup>6</sup> See discussion *infra* Part II.B-C, E regarding the *Eisenberg*, *Welch*, and *Dunn* cases.

<sup>7</sup> See discussion *infra* Part II.B-C regarding the *Eisenberg* and *Welch* cases.

<sup>8</sup> See discussion *infra* Part II.E and Part III regarding the *Dunn* and *Jelke* cases.

<sup>9</sup> Petition for a Writ of Certiorari, Comm'r v. Estate of Jelke, 2008 WL 2472932 (June 19, 2008) (No. 07-1582).

<sup>10</sup> Comm'r v. Estate of Jelke, 129 S. Ct. 168 (2008).

<sup>11</sup> Issues regarding discounts for lack of control and lack of marketability are often involved in cases concerning discounts for potential capital gains tax liability, but those discounts are beyond the scope of this article.

<sup>12</sup> Section 2031 provides: "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." I.R.C. § 2031(a) (2006).

That description is somewhat refined by § 2033 of the Code, which provides that the gross estate includes the decedent's property owned at death, "to the extent of the interest therein."<sup>13</sup> This generally includes the decedent's probate assets.<sup>14</sup>

The Code provisions are clarified in the Regulations—particularly in sections 20.2031-2 and 20.2031-3. Section 20.2031-3 of the Regulations specifies that the fair market value of a decedent's interest in a business is the "net" amount that a willing purchaser and a willing seller would agree upon, presuming that the transaction was voluntary and informed.<sup>15</sup> The value is to be based upon, among other things, an appraisal of the business's assets, earning capacity, and "other factors" listed in section 20.2031-2(f) of the Regulations.<sup>16</sup> These other factors include goodwill, economic outlook, industry position, degree of control, and values of similar businesses listed on an exchange.<sup>17</sup> Section 20.2031-2 of the Regulations generally discusses the valuation of stocks and bonds.<sup>18</sup> Section 20.2031-2(f) specifically discusses the valuation of stock where comparable prices are not available. This would typically be a situation involving closely held business interests. In such cases, consideration includes "net worth, prospective earning power and dividend paying capacity, and other relevant factors."<sup>19</sup> In addition to these factors, non-operating assets merit consideration in the valuation determination to the extent not otherwise considered.<sup>20</sup>

Revenue Ruling 59-60 is of additional significance to the statutory and regulatory posture of the capital gains tax deduction analysis.<sup>21</sup> The Ruling, which was originally promulgated in January, 1959, provides guidance in the valuation of

---

<sup>13</sup> I.R.C. § 2033 ("The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.").

<sup>14</sup> Treas. Reg. § 20.2031-1(a)(1) (as amended in 1965).

<sup>15</sup> *Id.* § 20.2031-3 (as amended in 1992).

<sup>16</sup> *Id.* § 20.2031-3(a)-(c).

<sup>17</sup> *Id.* § 20.2031-2(f)(2). The weight to be accorded these factors is based on the facts and circumstances of the particular case. *Id.*

<sup>18</sup> *Id.* § 20.2031-2.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> Rev. Rul. 59-60, 1959-1 C.B. 237 (amplified in Rev. Rul. 77-287, 1977-2 C.B. 319, Rev. Rul. 80-214, 1980-2 C.B. 171, and Rev. Rul. 83-120, 1983-2 C.B. 170) (modified in Rev. Rul. 65-193, 1965-2 C.B. 370).

stock of closely held businesses for estate and gift tax purposes.<sup>22</sup> The Ruling recognizes that valuation of such interests is not exact but rather calls on judgment, common sense, and reasonableness. The Ruling also identifies and discusses eight factors to be considered.<sup>23</sup> In particular, in discussing book value and financial condition, the Ruling says that non-operating assets, including securities and real estate investments, should be included.<sup>24</sup> Investment assets are to be considered at market, rather than book, value.<sup>25</sup>

The Ruling also discusses the weight to be accorded the various factors. In operating businesses, earning capacity should take precedence.<sup>26</sup> For investment companies, asset value is primary.<sup>27</sup> In fact, the Ruling states that net asset value should be accorded greater weight in valuing real estate or investment companies than earnings or dividend-paying capacity.<sup>28</sup>

## II. THE CASE LAW BACKGROUND

The discussion of whether and how much to deduct from the value of a closely held business for the amount attributable to the contingent tax on capital gains residing in such business dates back to the 1935 case *General Utilities &*

---

<sup>22</sup> *Id.* § 1. A closely held business is one in which there are a relatively small number of owners and no ready market for the sale of an ownership interest. *Id.* at § 2.03.

<sup>23</sup> The factors, not exclusive of others, are considered “fundamental” and are as follows: “the nature of the business and the history of the enterprise since its inception,” “the economic outlook in general and the condition and outlook of the specific industry in particular,” “the book value of the stock and the financial condition of the business,” “the earning capacity of the company,” “the dividend paying capacity,” “whether or not the enterprise has goodwill or other intangible value,” “sales of the stock and the size of the block of stock to be valued,” and “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.” *Id.* § 4.01(a)-(h).

<sup>24</sup> *Id.* § 4.02(c).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* § 5(a).

<sup>27</sup> *Id.*

<sup>28</sup> “For companies of this type, the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company *and the cost of liquidating it*, if any, merit consideration when appraising the relative values of the stock and the underlying assets . . . adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any other customary yardsticks of appraisal, such as earnings or dividend paying capacity.” *Id.* § 5(b) (emphasis added). The taxes payable on liquidation could be considered part of the cost of liquidation.

*Operating Co. v. Helvering*.<sup>29</sup> In *General Utilities*, the United States Supreme Court held that there was no entity level tax on a distribution of appreciated property to shareholders, creating the so-called “*General Utilities doctrine*.”<sup>30</sup> The doctrine was codified in I.R.C. §§ 311(a), 336 and 337.<sup>31</sup> In 1986, as part of the Tax Reform Act of 1986, Congress eliminated the *General Utilities doctrine* from the Code.<sup>32</sup> Section 336 now states that a corporation should treat a liquidating distribution of property to shareholders as a sale.<sup>33</sup> Section 311(b) now also provides that if a company distributes property which has a fair market value in excess of the company’s basis in that property, the company must treat the transaction as a sale even if it is not in complete liquidation.<sup>34</sup> The recipient of such a distribution in complete liquidation is treated as having received payment in full in exchange for their stock (i.e., capital gain taxation).<sup>35</sup> The 1986 change to §§ 311 and 336 created the issue of whether the potential corporate level capital gains tax should be deducted in computing the value of the closely held business for estate and gift tax purposes and, if so, the proper amount of that deduction. Several cases preceding *Jelke* considered the issue, but the holdings of those cases were inconsistent and resulted in circuit splits. This discussion now turns to the most prominent cases preceding the *Jelke* decision.

---

<sup>29</sup> *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

<sup>30</sup> *Id.* at 206.

<sup>31</sup> Section 311(a) formerly provided that “no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of 1) its stock (or rights to acquire its stock), or 2) property.” I.R.C. § 311(a) (1954) (amended 1986). Section 336 formerly provided that “no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.” *Id.* § 336. Section 337 formerly provided that if a corporation distributed all its assets in complete liquidation within twelve months of adoption of a plan of liquidation, no gain or loss would be recognized by the corporation. *Id.* § 337.

<sup>32</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

<sup>33</sup> I.R.C. § 336(a) now provides that “gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at fair market value.” I.R.C. § 336(a) (2006). Section 337 now provides for non-recognition of gain or loss on distributions by an 80% owned subsidiary to its parent in complete liquidation. *Id.* § 337(a).

<sup>34</sup> *Id.* § 311(b)(1). Section 311(a) now states that no gain or loss is recognized to a corporation on a distribution not in complete liquidation of its stock or property *except* as provided in subsection (b). *Id.* § 311(a) (emphasis added).

<sup>35</sup> *Id.* § 331(a). Generally, if a distribution of property is not in complete liquidation, a shareholder will have dividend income to the extent of current and accumulated earnings and profits, no income (to the extent of their basis in the stock), and then capital gain income for any remaining amount of the distribution. *Id.* § 301(a)-(c).

### A. *Davis v. Commissioner*

The decedent in *Davis v. Commissioner* died as the beneficiary of a trust that owned all the stock of a closely held corporation.<sup>36</sup> That corporation held various assets, including 1.328% of the outstanding common stock of Winn-Dixie Stores, Inc.<sup>37</sup> The Winn-Dixie stock alone was valued at \$70 million.<sup>38</sup> Prior to the decedent's death, he gifted approximately 25% of the holding company's stock to each of his two sons.<sup>39</sup> These gifts were valued for gift tax purposes at approximately \$7.5 million per gift.<sup>40</sup> The IRS contested the value, alleging it was approximately \$12 million per block.<sup>41</sup> Sales of Winn-Dixie stock by the decedent, the holding company, and the trust were restricted under Securities and Exchange Commission Rule 144.<sup>42</sup> The issues in the case were the amount of any discounts for the minority positions of the blocks, their lack of marketability, and the sizable capital gains tax residing in the holding company if the Winn-Dixie stock, in particular, were to be liquidated.<sup>43</sup>

The IRS took the position that no built-in gains tax discount should be employed in the case because there was no planned or contemplated liquidation of the business.<sup>44</sup> Indeed, prior to this case, the Tax Court had held that no such

---

<sup>36</sup> *Davis v. Comm'r*, 110 T.C. 530, 531-32 (1998).

<sup>37</sup> *Id.* The *Davis* case (and the *Eisenberg* case, discussed below) involved valuation issues in the gift tax (not estate tax) context. Because the federal estate and gift tax systems are "unified," the valuation issues for gift tax purposes are the same as those for estate tax, except for the date on which the valuation is made—the date of the gift for gift tax and date of death for the estate tax. The valuation regulations for gift tax mirror those of the estate tax.

<sup>38</sup> *Id.* at 533.

<sup>39</sup> *Id.* at 531.

<sup>40</sup> *Id.* at 534.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.* at 532. Rule 144 restricts the timing and amount of resales of closely held stock issued pursuant to a federal securities law registration exemption. It is, therefore, an impediment to the marketability of such stock, which reduces its fair market value. *See* 17 C.F.R. 230.144 (2008).

<sup>43</sup> *See Davis*, 110 T.C. at 530. The basis of all the Winn-Dixie stock in the holding company was about \$338,000, for a gain of approximately \$69.6 million as of the valuation date. The total capital gains tax at the time would have been nearly \$26 million. *Id.* at 533-34.

<sup>44</sup> *Id.* at 547. The petitioner had stipulated that there was no planned or contemplated liquidation of the business. *Id.*

discount should be accorded where liquidation was not planned or was speculative.<sup>45</sup> Here, however, the Tax Court changed course.

In consideration of the Commissioner's concession that if liquidation did occur or if avoidance of the tax was not accomplished by conversion to an S corporation, a substantial tax would be due, the court held that some reduction in value was appropriate.<sup>46</sup> After parsing through various expert valuations, the court held that even though no liquidation was contemplated, hypothetical buyers and sellers of the stock would have considered the effect of the tax in determining a price.<sup>47</sup> The IRS's position was likely undermined by its own expert, who had included some discount for the tax effect as part of the marketability discount.<sup>48</sup> The court distinguished the cases relied upon by the IRS as either predating the repeal of the *General Utilities* doctrine in 1986 or as cases where the taxpayer sought a 100% reduction for the capital gains tax.<sup>49</sup> That argument had been rejected in these cases because there was no contemplated liquidation.<sup>50</sup> In its holding, the *Davis* court granted a discount for some, but less than a full, built-in gains tax effect, but incorporated it as part of the discount for a lack of marketability.<sup>51</sup> Thus, the *Davis* case marked a breakthrough in the Tax Court's treatment of the discount.<sup>52</sup>

---

<sup>45</sup> *Id.* at 546-47 (citing *Estate of Luton v. Comm'r*, 68 T.C.M. (CCH) 1044 (1994); *Estate of Bennett v. Comm'r*, 65 T.C.M. (CCH) 1816 (1993); *Ward v. Comm'r*, 87 T.C. 78 (1986); *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982); *Estate of Piper v. Comm'r*, 72 T.C. 1062 (1979); *Estate of Cruikshank v. Comm'r*, 9 T.C. 162 (1947); *Messing v. Comm'r*, 48 T.C. 502 (1967); *Mandelbaum v. Comm'r*, 69 T.C.M. (CCH) 2852 (1995); *Estate of Ford v. Comm'r*, 66 T.C.M. (CCH) 1507 (1993)).

<sup>46</sup> *Id.* at 547-48. Conversion to an S Corporation is generally unattractive because assets must be held for ten years to avoid taxation on the built-in gains. *See* I.R.C. § 1374(a), (d)(7) (2006).

<sup>47</sup> *Davis*, 110 T.C. at 550.

<sup>48</sup> *Id.* at 552.

<sup>49</sup> *Id.* at 551-52. As previously discussed, no tax would have been due under the *General Utilities* doctrine. *See supra* note 31 and accompanying text.

<sup>50</sup> As to the taxpayer's claim for a full reduction for the amount of the tax, the court stated that since no sale of assets was contemplated, the full amount of the tax could not be used as a discount. Some discount, however, was appropriate because complete avoidance of the tax was unlikely and would therefore affect the amount a willing buyer would pay. *Davis*, 110 T.C. at 552-53.

<sup>51</sup> *Id.* at 553. The total tax was approximately \$26.7 million. The court took the net asset value of the company, applied a 15% minority discount, and adjusted for a lack of marketability, totaling \$29 million. Of the \$29 million, \$9 million was attributable to the built-in gain tax.

The \$9 million was between the amounts calculated by the experts for both sides (one of taxpayer's experts computed a full tax discount, the other taxpayer expert and the IRS's expert computed a partial tax discount). The Tax Court did not allow any discount for the Rule 144 resale restrictions

### B. *Eisenberg v. Commissioner*

Two months after the *Davis* decision, the Second Circuit weighed in on the debate in *Eisenberg v. Commissioner*.<sup>53</sup> In *Eisenberg*, which (like *Davis*) involved a valuation issue with respect to the gift tax, the Second Circuit took a more aggressive position on the existence and amount of the tax discount. The *Eisenberg* case involved an appeal of a grant of summary judgment by the Tax Court, which had rejected a taxpayer's claimed discount for the full amount of built-in gains tax that would have been owed had the taxpayer's wholly-owned corporation liquidated or distributed its sole asset.<sup>54</sup>

That sole asset of the C-corporation was a commercial building which it leased to others.<sup>55</sup> Over three years, the taxpayer gifted stock in the corporation to her child and grandchildren.<sup>56</sup> The value of the building was determined each year, and each year the value was reduced by the full amount of the capital gains tax that would have been assessed.<sup>57</sup> *Eisenberg* conceded that there were no plans to sell or distribute the building.<sup>58</sup> Over the three years, the IRS claimed gift tax deficiencies that totaled almost \$62,000—all attributable to the claimed tax effect discount.<sup>59</sup> The sole issue considered by the Second Circuit was the appropriateness of the tax discount.<sup>60</sup>

In granting the IRS's motion for summary judgment, the Tax Court had relied on the line of cases established before the repeal of the *General Utilities*

---

because the taxpayer had not satisfied his burden of proof that he was entitled to such a discount, nor its amount. *Id.* at 544.

<sup>52</sup> The Tax Court stated its new view: "[I]n determining the fair market value on the valuation date of each of the blocks of stock at issue, it is necessary to apply a discount or adjustment attributable to . . . built-in capital gains tax because that is what a hypothetical willing seller and hypothetical willing buyer would have done under the facts and circumstances existing on that date." *Id.* at 552.

<sup>53</sup> *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998).

<sup>54</sup> *Eisenberg v. Comm'r*, 74 T.C.M. (CCH) 1046 (1997).

<sup>55</sup> *Eisenberg*, 155 F.3d at 51.

<sup>56</sup> *Id.* at 52.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup>*Id.* All other issues in the case were stipulated by the parties. *Id.* at 52.

doctrine, which held that no such discount was permitted.<sup>61</sup> These holdings were correct under *General Utilities* and the pre-1986 Code because there was no tax at the corporate level on a distribution of appreciated property. On appeal, the Second Circuit considered whether, given the 1986 amendments to the Code, a tax discount should be allowed where there was no plan to sell or distribute corporate assets.<sup>62</sup> The taxpayer argued that the hypothetical buyer and seller would undoubtedly reduce the corporation's value by the amount of that tax liability.<sup>63</sup> The IRS argued that no such tax would be incurred if a buyer bought the company stock and continued leasing the building and, given that there were no plans to sell or distribute the building, any estimate of the amount would be unduly speculative.<sup>64</sup>

The Second Circuit sided with the taxpayer. First, like the Tax Court in *Davis*, the panel rejected the precedential value of the cases occurring before the repeal of *General Utilities*.<sup>65</sup> Second, the court emphasized that in determining fair market value based on a hypothetical buyer and seller, it was a *hypothetical* buyer and seller—not actual ones—who should be considered.<sup>66</sup> According to the court, it was not speculative that a hypothetical buyer would demand a discount for the unavoidable capital gains tax.<sup>67</sup> Further, that potential tax liability would have a depressing effect on the fair market value of the property, and the fair market value of the property was what was ultimately being sought.<sup>68</sup> The court cited *Davis* in support of its holding.<sup>69</sup>

Notably, the Second Circuit left open the issue of the amount of the discount. In a footnote, the court stated:

---

<sup>61</sup> The Tax Court relied on *Ward v. Commissioner*, 87 T.C. 78 (1986), *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982), *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979), and *Estate of Cruikshank v. Commissioner*, 9 T.C. 162 (1947). *Id.* at 54. The Tax Court also cited *Gallun v. Commissioner*, 33 T.C.M. (CCH) 1316 (1974) as a *General Utilities* era case supporting the idea that if there were no immediate plans to liquidate, a capital gains tax discount was too speculative. *Id.* at 57.

<sup>62</sup> *Id.* at 55-56.

<sup>63</sup> *Id.* at 56.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 57.

<sup>66</sup> *Id.* (quoting *Curry v. United States*, 706 F.2d 1424, 1428-29 (7th Cir. 1983)).

<sup>67</sup> *Id.* at 57 (noting that it is indisputable that a hypothetical buyer would demand some discount in price because of the inability to avoid the tax liability).

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 58.

One might conclude from this example that the full amount of the 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.* In this case we are only addressing how potential tax consequences . . . may affect the fair market value of the shares of stock appellant gifted to her relatives in contrast to the fair market value of the real estate.<sup>70</sup>

The case was then remanded to the Tax Court for a determination of the gift tax deficiency. The Commissioner later acquiesced to the Second Circuit decision.<sup>71</sup>

### C. *Estate of Welch v. Commissioner*

In *Estate of Welch v. Commissioner*, an unpublished decision rendered in early 2000, the Sixth Circuit overturned a Tax Court ruling that denied an estate tax valuation discount for potential capital gains tax liability.<sup>72</sup> According to the Tax Court, the potential for a § 1033 election made the possibility of such a tax too speculative to grant a discount.<sup>73</sup> On appeal, the IRS conceded that some discount was permissible but argued that the taxpayer had failed to prove the appropriate amount.<sup>74</sup>

First, the Sixth Circuit found that the potential availability of the § 1033 election would be a consideration of a hypothetical buyer. The court held, however,

---

<sup>70</sup> *Id.* at 58 n.15 (emphasis added).

<sup>71</sup> *Eisenberg v. Comm’r*, 155 F.3d 50 (2d Cir. 1998), *action on dec.*, 1999-01 (Jan. 28, 1999). In its Action on Decision, the IRS stated, “We acquiesce in the opinion to the extent that it holds that there is no legal prohibition against such a discount. The applicability of such a discount, as well as the amount, will hereafter be treated as factual matters to be determined by competent expert testimony based on the circumstances of each case and generally applicable valuation principles.” *Id.*

<sup>72</sup> *Estate of Welch v. Comm’r*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. Mar 1, 2000).

<sup>73</sup> Section 1033 generally provides that no gain is recognized on the involuntary conversion of property if the property is converted to a similar or related use or if non-similar property or money is received and is used to replace the converted property within two years, except to the extent any amount received on conversion exceeds the basis in the property converted, assuming the taxpayer makes a timely election to do so. I.R.C. § 1033(a)(1)-(2) (2006).

<sup>74</sup> *Welch*, 2000 U.S. App. LEXIS 3315, at \*6.

that such a consideration did not automatically negate a capital gains tax discount.<sup>75</sup> Thus, the Sixth Circuit reversed the Tax Court's holding.<sup>76</sup>

The Sixth Circuit remanded the case to the Tax Court for a determination of the proper amount of the discount.<sup>77</sup> In its remand, the Sixth Circuit stated that "petitioners *may not* be entitled to deduct the *full* amount of that liability . . . ."<sup>78</sup> Thus, the court left open the issue of whether a discount of the full amount of the tax liability was possible.

#### D. *Estate of Jameson v. Commissioner*

In *Estate of Jameson v. Commissioner*, a decedent's estate contained 80,485 shares of stock in a holding company.<sup>79</sup> The IRS had assessed a deficiency in the decedent's estate tax based on an alleged undervaluation of the holding company stock.<sup>80</sup> The Tax Court agreed, although its valuation differed from that of the Service.<sup>81</sup> The estate appealed, contending (among other things) that it was entitled to a full discount for the capital gains tax liability attributable to certain appreciated property residing in the holding company.<sup>82</sup> The Fifth Circuit overturned the Tax Court's valuation and its method of discounting the capital gains tax liability.<sup>83</sup>

The holding company owned 5,405 acres of timber property, which it licensed to others in return for a fee.<sup>84</sup> These fees accounted for about 80% of the holding company's revenue.<sup>85</sup> The property itself was worth \$6 million at the time of

---

<sup>75</sup> *Id.* at \*14-15.

<sup>76</sup> *Id.* at \*16 ("The error of the Tax Court was holding, as a matter of law, that the availability of a § 1033 election prevented *any* discount in the value of the corporation's stock.").

<sup>77</sup> *Id.* at \*17.

<sup>78</sup> *Id.* at \*20 (emphasis added).

<sup>79</sup> *Estate of Jameson v. Comm'r*, 267 F.3d 366, 367 (5th Cir. 2001).

<sup>80</sup> *See generally* *Estate of Jameson v. Comm'r*, 77 T.C.M. (CCH) 1383 (1999), 1999 Tax Ct. Memo LEXIS 42.

<sup>81</sup> *See generally id.*

<sup>82</sup> *Jameson*, 267 F.3d at 371.

<sup>83</sup> *Id.* at 375.

<sup>84</sup> *Id.* at 368.

<sup>85</sup> *Id.*

the decedent's death.<sup>86</sup> Another piece of real estate the company owned was worth \$240,000.<sup>87</sup> The company's bases in the properties were \$217,850 and \$110,740, respectively, which would have resulted in a \$5.9 million gain if the property were sold or distributed.<sup>88</sup> The dispute in this aspect of the case concerned whether and to what extent a discount for potential capital gains tax liability should be factored into the estate tax valuation.<sup>89</sup> The Tax Court allowed no discount for the less valuable property because the parties had not presented evidence on the issue.<sup>90</sup> It permitted a built-in gains tax discount on the timber property but "discounted the discount" to reflect a presumption that the timber property would not be liquidated immediately but over time.<sup>91</sup>

The Fifth Circuit rejected the Tax Court's approach.<sup>92</sup> The Fifth Circuit held that the Tax Court erred because it had assumed a "strategic" or actual buyer of Johnco rather than the required "hypothetical" buyer.<sup>93</sup> According to the circuit court, a hypothetical buyer would act in the most economically rational way and liquidate the property because the return available for continued operation was below that which a buyer would demand.<sup>94</sup> This computation invalidated the Tax

---

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 369.

<sup>88</sup> *Id.* at 368-69.

<sup>89</sup> *Id.* at 371.

<sup>90</sup> *Jameson*, 77 T.C.M. (CCH) 1383, 1999 Tax Ct. Memo LEXIS 42, at \*59 n.27. On appeal, the Fifth Circuit also directed the Tax Court to apply a tax discount with respect to this property. *Jameson*, 267 F.3d at 373-74.

<sup>91</sup> *Jameson*, 77 T.C.M. (CCH) 1383, 1999 Tax Ct. Memo LEXIS 42, at \*57. The Tax Court first said that Johnco would realize gains on the sale of its timber pursuant to its election under IRC § 631(a). *Id.* A § 631(a) election treats the cutting of timber as a deemed sale, and the cut timber acquires the value at the time of cutting as the tax basis when it is then sold, which is then ordinary income. I.R.C. § 631(a) (2006). Gain was thus unavoidable even if there were no liquidation of the company. The court determined that it would take nine years to fully recognize the built-in gains and utilized a 20% discount rate to determine the present value of the capital gains tax. *Jameson*, 77 T.C.M. (CCH) 1383, 1999 Tax Ct. Memo LEXIS 42, at \*58-59. This approach was also utilized by the Tax Court in the post-*Davis*, post-*Eisenberg*, post-*Welch*, and post-*Jameson* decisions of *Estate of Dailey v. Commissioner*, 82 T.C.M. (CCH) 90, at 7-8 (2001) (merely accepting taxpayer's expert's inclusion of an amount for built-in gain taxes in the marketability discount without comment), and *Borgatello v. Commissioner*, T.C.M. (RIA) 54013, at 33-36 (2000).

<sup>92</sup> *Jameson*, 267 F.3d 366 at 371-72.

<sup>93</sup> *Id.* at 371.

<sup>94</sup> *Id.* at 372 ("The hypothetical willing buyer/willing seller test substitutes evidence of the actual owner's or purchaser's intent with the most economically rational analysis of a sale."). The projected

Court's valuation, which had been based on continued operation and sale over time. Although the Fifth Circuit did not indicate the amount of the capital gains tax liability discount, it notably said, "the [Tax Court's] misplaced emphasis on a purchaser engaged in long-run timber production led to its peremptory denial of a *full discount* for the accrued capital gains liability."<sup>95</sup> Later courts would view that language as justifying a full discount for the tax liability.<sup>96</sup>

### E. *Dunn v. Commissioner*

In an extension of its holding in *Jameson*, the Fifth Circuit in *Dunn v. Commissioner* granted a taxpayer a full discount for the value of the capital gain tax liability attributable to certain appreciated property owned by a closely held business.<sup>97</sup> The stock of that company formed a part of a decedent's estate.<sup>98</sup>

The closely held business in this case was not a holding company; rather, its principal business was the leasing of heavy equipment.<sup>99</sup> At the time of the decedent's death, the business's assets consisted primarily of equipment, some real estate, and prepaid expenses and interest.<sup>100</sup> The decedent owned about 63% of the business's outstanding stock, but that was not enough under Texas law to force a liquidation of the company.<sup>101</sup>

The Fifth Circuit faced two issues in this appeal: (1) the amount of any built-in capital gains tax liability discount and (2) the weight to assign to different measures of value—the earnings-based value for the operating portion of the business and the asset-based value for the non-operating portion. The Tax Court had allowed a 5% tax discount and a weighting of 35% to the earnings based value and 65% to the asset based value.<sup>102</sup> The Fifth Circuit disagreed with both

---

return from continued operation was 14%, while the expected return necessary for the hypothetical buyer was 20%. *Id.* The Fifth Circuit called the Tax Court's assumptions "internally inconsistent" and "fatally flawed." *Id.*

<sup>95</sup> *Id.* (emphasis added).

<sup>96</sup> See discussion *infra* Part II.E-F.

<sup>97</sup> *Dunn v. Commissioner*, 301 F.3d 339, 351 (5th Cir. 2002).

<sup>98</sup> *Id.* at 342.

<sup>99</sup> *Id.* at 344.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 346 (noting that Texas law required at least a 2/3 vote to force a liquidation).

<sup>102</sup> Estate of *Dunn v. Comm'r*, 79 T.C.M. (CCH) 1337, at 17, 33 (2000).

conclusions. Of relevance to this article is the court's analysis of the tax discount issue.<sup>103</sup>

The Fifth Circuit found that the amount of potential gain if the equipment and real estate were sold and the rate of tax (34%) was undisputed.<sup>104</sup> The issue was how to account for that tax liability in determining valuation. The taxpayer argued for a full discount for the amount of the potential tax and the Service argued for no discount because no sale was contemplated.<sup>105</sup> As stated previously, the Tax Court had reduced the discount to 5%, finding that a hypothetical buyer would not demand a discount unless they contemplated a sale of the assets.<sup>106</sup> The meager 5% discount represented the unlikelihood of that possibility.<sup>107</sup>

The Fifth Circuit described the Tax Court's analysis in this regard as "simply wrong,"<sup>108</sup> holding that a hypothetical buyer would demand a full discount for the tax liability regardless of future intentions.<sup>109</sup> The court stated:

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.<sup>110</sup>

The court found that the likelihood of liquidation did not enter the equation of the amount of the discount, but rather only the allocation of weights between the

---

<sup>103</sup> The Fifth Circuit revised the weight allocation to be 85% earnings based and 15% asset based. *Dunn*, 301 F.3d at 358-59. The Tax Court's determination of value also included discounts for lack of marketability (15%) and lack of super-majority control (7.5%). These discounts were not contested on appeal. *Id.* at 347.

<sup>104</sup> *Id.* at 351.

<sup>105</sup> *Id.* at 351-52. The IRS argued for no discount because "liquidation was not imminent or even likely." *Id.* at 352.

<sup>106</sup> *Dunn*, 79 T.C.M (CCH) 1337, 32-33.

<sup>107</sup> *Id.* at 33.

<sup>108</sup> *Dunn*, 301 F.3d at 352.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at 352-53.

earnings and asset based valuation methods.<sup>111</sup> For purposes of the asset-based valuation, the appellate court unanimously held that the assumption of a sale was automatic.<sup>112</sup> In its conclusion of this aspect of its decision, the court reiterated that “determination of the value of [the business] must include a reduction equal to 34% of the taxable gain inherent in those assets as of the valuation date.”<sup>113</sup> By this time this case was decided, the *Jelke* case was already on the horizon.

### III. THE JELKE DECISION

#### A. The Facts

The facts underlying *Estate of Jelke v. Commissioner*<sup>114</sup> are summarized as follows: Commercial Chemical Company (CCC), a closely held C corporation and former operating company, had marketable securities as its only assets.<sup>115</sup> The decedent, Frazier Jelke, died on March 4, 1999, possessing a 6.44% interest in CCC through a revocable trust.<sup>116</sup> The total net asset value of CCC on the date of Jelke’s death was approximately \$188 million, and the total capital gain tax liability if the securities had been sold on that date would have amounted to just over \$51 million.<sup>117</sup> On Jelke’s estate tax return, his interest in CCC was valued at \$4.5 million, which reflected a reduction in the net asset value for the full amount of the capital gain tax liability, a 20% discount for lack of control, and a 35% discount for lack of marketability.<sup>118</sup> The IRS partially accepted the discounts for lack of control and marketability, but issued a deficiency notice asserting that Jelke’s interest was actually worth \$9.1 million.<sup>119</sup> The IRS reduced the full discount for the potential tax liability

---

<sup>111</sup> *Id.* at 354. The court stated that the less likely a liquidation, the greater the weight to be given the earnings-based value; the greater the likelihood, the greater the weight to be given the asset-based calculation. *Id.*

<sup>112</sup> *Id.* at 353 (describing the sale of the assets as a “foregone conclusion”).

<sup>113</sup> *Id.* at 354.

<sup>114</sup> *Estate of Jelke v. Comm’r*, 507 F.3d 1317 (11th Cir. 2007), *cert.denied*, 129 S. Ct. 168 (2008).

<sup>115</sup> *Estate of Jelke v. Comm’r*, 89 T.C.M. (CCH) 1397 (2005), 2005 Tax Ct. Memo LEXIS 128, at \*1.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at \*8.

<sup>119</sup> *Id.* at \*8-9.

to the present value of asset sales conducted over a 16.8 year period.<sup>120</sup> The estate contested the deficiency in Tax Court in March of 2003.

### **B. The Tax Court Decision**

Although there were issues in the Tax Court regarding the amount of discounts for lack of control and marketability, the focus of this article and of the Eleventh Circuit concerns the capital gains tax discount.<sup>121</sup> The taxpayer argued that *Dunn*,<sup>122</sup> was apposite to this case and required a valuation based on liquidation at the date of death with a consequent reduction in value for the full amount of the projected tax.<sup>123</sup> The taxpayer also argued that, due to CCC's low dividend payout rate, a buyer would opt for liquidation.<sup>124</sup> The Tax Court disagreed, distinguishing from *Dunn* on the grounds that *Dunn* was a nonbinding decision from another circuit and that *Dunn* involved a majority interest (whereas Jelke's interest was only 6.44%).<sup>125</sup>

Concerning valuation determination, the Tax Court agreed with the Commissioner's valuation expert.<sup>126</sup> The Tax Court found that based on recent history, the asset turnover rate of CCC averaged 5.95% per year, meaning it would take 16.8 years for the entire portfolio to turn over.<sup>127</sup> Dividing the total potential capital gain tax of \$51,626,884 by 16.8 resulted in an average capital gain tax of \$3,226,680 per year.<sup>128</sup> Using a discount rate of 13.2%, this average was discounted

---

<sup>120</sup> *Id.* at \*25.

<sup>121</sup> The Tax Court determined the appropriate discounts for control and marketability to be 10% and 15%, respectively. *Id.* at \*45, \*53. The Eleventh Circuit affirmed those amounts without discussion in a footnote. *Estate of Jelke v. Comm'r*, 507 F.3d 1317, 1319 n.4 (11th Cir. 2007).

<sup>122</sup> *See* discussion *supra* Part II.E.

<sup>123</sup> *Jelke*, 89 T.C.M. (CCH) 1397, 2005 Tax Ct. Memo LEXIS 128, at \*28-29.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* at \*29-30 (holding that "neither the circumstances of this case nor the theory or method used to value the minority interest in CCC requires an assumption of complete liquidation on the valuation date"). The Court did not discuss why this factual difference in the cases mattered to the discount issue. *Id.* In *Dunn*, the taxpayer's lack of super-majority power was only relevant in determining the amount of the control discount. *See supra* note 103 and accompanying text.

<sup>126</sup> *Jelke*, 89 T.C.M. (CCH) 1397, 2005 Tax Ct. Memo LEXIS 128, at \*15.

<sup>127</sup> *Id.* at \*25.

<sup>128</sup> *Id.* at \*26.

to a present value of approximately \$21 million.<sup>129</sup> That made Jelke's share (before control and marketability discounts) about \$10.8 million.<sup>130</sup> Jelke's expert had calculated this amount to be \$8.8 million based on a full deduction of the \$51 million capital gains tax liability.<sup>131</sup> After application of the control and marketability discounts, the Tax Court held that Jelke's interest should be valued at \$8,254,696 rather than the estate's claim of \$4,588,155.<sup>132</sup> The taxpayer appealed.

### C. The Eleventh Circuit Decision<sup>133</sup>

The *Jelke* appellate court decision is particularly helpful because the value and basis of all the assets of CCC were clear, known, and agreed upon.<sup>134</sup> Also, the appellate court accepted, without discussion, the lack of control and lack of marketability discounts.<sup>135</sup> Therefore, the only issue addressed by the Eleventh Circuit involved the handling of the discount for the hypothetical capital gains tax.<sup>136</sup> In a 2-1 decision, the court reversed the decision of the Tax Court.<sup>137</sup>

After thoroughly reviewing the history of applicable case law beginning with *General Utilities*,<sup>138</sup> the majority applied the existing case law to the *Jelke* facts<sup>139</sup>. Estate tax valuation was described as being based on the "arbitrary assumption that a liquidation takes place on the date of death."<sup>140</sup> On this date, a "snap shot" of value

---

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at \*24. The estate's expert and the Commissioner's expert agreed that the date-of-death value of the marketable securities was \$188,635,833. *Id.* at \*25. The estate's expert then deducted the full hypothetical capital gains tax amount of \$51,626,884 and multiplied the result by Jelke's 6.44% interest to arrive at \$8,823,062 (before control and marketability discounts). *Id.* at \*24-25.

<sup>132</sup> *Id.* at \*53. The estate had argued for control and marketability discounts of 25 and 35 percent, respectively, but the Tax Court settled at 10 and 15 percent. *Id.* at \*36.

<sup>133</sup> *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007), *cert.denied*, 129 S. Ct. 168 (2008).

<sup>134</sup> *Id.* at 1318 n.3. The assets involved in *Jelke* were all marketable securities. *Id.*

<sup>135</sup> *Id.* at 1319 n.4.

<sup>136</sup> *Id.* at 1321.

<sup>137</sup> Citing its recent decision in *Estate of Blount v. Commissioner*, 428 F.3d 1338, 1346 (11th Cir. 2005), the *Jelke* appellate court stated that the notion of a hypothetical buyer ignoring the built-in gains tax liability "strains credulity and defies any sensible construct of fair market value." *Id.* at 1331.

<sup>138</sup> *Id.* at 1322-33.

<sup>139</sup> *Id.* at 1334.

<sup>140</sup> *Id.* at 1331.

is taken.<sup>141</sup> Without a great deal of discussion, the Eleventh Circuit majority adopted the *Dunn* approach<sup>142</sup> as consistent with the notion of a “snap shot” and presumed liquidation as of the date of death.<sup>143</sup> The court held that this method avoided the uncertainty and speculation of other methods that sought to project sales into the future and then discounted them back to the present value.<sup>144</sup>

The majority conceded that its approach contained an element of arbitrariness.<sup>145</sup> However, the court found that any method other than a full discount for the capital gains tax lacked certainty and engaged in the kind of speculation opposed by the IRS.<sup>146</sup> The court held that *Dunn* “eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking.”<sup>147</sup>

The court’s adherence to *Dunn* resulted in acceptance of the \$51 million discount argued by the taxpayer.<sup>148</sup> The Commissioner filed a petition for certiorari with the United States Supreme Court on June 19, 2008.<sup>149</sup> It was denied four months later.<sup>150</sup>

---

<sup>141</sup> *Id.*

<sup>142</sup> See discussion *supra* Part II.E (discussing the *Dunn* approach).

<sup>143</sup> *Id.* at 1332.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 1331. However, the court noted that a hypothetical buyer would logically demand the full discount because they could otherwise purchase the same mix of investments in the market that CCC possessed without incurring the tax risk. *Id.*

<sup>146</sup> *Id.* at 1332 (noting that utilizing the Tax Court’s methodology “could cause the Commissioner to revive his ‘too speculative a tax’ contentions made prior to the Estate of Davis in 1998”).

<sup>147</sup> *Id.* at 1332-33.

<sup>148</sup> *Id.* at 1333.

<sup>149</sup> Petition for Writ of Certiorari, *Comm’r v. Estate of Jelke*, 129 S. Ct. 168 (2008) (No. 07-1582), 2008 WL 2472932. The questions presented by the writ were as follows:

1. Whether the fair market value of property for purposes of the federal estate tax, including selection of an appropriate valuation methodology, is a question of fact, reviewed for clear error.

2. Whether the court of appeals erred in holding, as a matter of law, that whenever a company’s fair market value for estate tax purposes is determined based on its net asset value, there must be a dollar-for-dollar discount for any built-in gains tax liability based on the arbitrary assumption that the company was liquidated on the valuation date.

#### D. The Jelke Dissent

Judge Carnes dissented from the majority holding, arguing that his colleagues had opted for the easier but less accurate valuation determination.<sup>151</sup> He urged upholding the Tax Court decision as one resulting in a value closer to “real.”<sup>152</sup> Judge Carnes found it highly unlikely that a prospective buyer would contemplate liquidating a company that had an average annual return of 23% and sizable unrealized capital gains.<sup>153</sup> Rather, he thought the Tax Court view that CCC would continue its turnover rate at about 6% per year was more reasonable and likely.<sup>154</sup> According to the dissent, although a prospective buyer would demand some discount for the prospective capital gains, such a buyer could not reasonably expect a full discount because no seller would provide it.<sup>155</sup>

Further, Judge Carnes argued, if the methodology of the majority was sound, it should be applied in other contexts, such as the computation of damage awards in tort cases.<sup>156</sup> Otherwise, he said—mocking the majority opinion with its own words—courts are engaging in “prophesying,” “hunt-and-peck forecasting,” “flipping a coin,” or “gazing into a crystal ball.”<sup>157</sup> Judge Carnes also accused the majority of succumbing to “ignoble ease” and “seductive simplicity” at the cost of greater accuracy and realism.<sup>158</sup> According to the dissent, the simplicity trumpeted by the majority came at the price of arbitrariness.<sup>159</sup> Based on its more sophisticated—

---

*Id.* at \*I.

<sup>150</sup> *Comm’r v. Estate of Jelke*, 129 S. Ct. 168 (2008).

<sup>151</sup> *Jelke*, 507 F.3d at 1334 (Carnes, J., dissenting).

<sup>152</sup> *Id.* at 1335.

<sup>153</sup> *Id.* at 1336 (referring to the notion of a prospective buyer liquidating the company’s assets as “preposterous”).

<sup>154</sup> *Id.*

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 1337.

<sup>157</sup> *Id.* at 1338.

<sup>158</sup> *Id.* at 1337.

<sup>159</sup> *Id.* at 1339. As previously discussed, the majority conceded as much although they contended that the benefits of certainty, simplicity, clarity, consistency, and finality outweighed the apparent arbitrariness of their methodology. *Id.* at 1333 (majority opinion).

and in Carnes's view, more rational—approach, the dissent argued that the decision of the Tax Court should have been affirmed.<sup>160</sup>

#### IV. ANALYSIS

The Code and Regulations indicate that valuation of assets for estate tax purposes should be made at the time of death (unless alternate valuation is elected)<sup>161</sup> and that the fair market value of closely held stock should be based on what a hypothetical buyer and seller would agree upon as a price.<sup>162</sup> This mandate creates the issue that is the subject of this article. While it is quite sensible that the estate tax value is determined as of the date of death (or gift tax value be determined as of the date of the gift) and that the value be a “fair market value,” it is less clear, but certainly defensible, that fair market value should be derived from a “hypothetical” buyer and seller. Several courts have distinguished the hypothetical buyer and seller from “actual” or “strategic” ones, and that distinction has led to different outcomes.<sup>163</sup> Furthermore, the Regulations do not specifically define how a hypothetical buyer or seller behaves. The Regulations do say that both should be considered knowledgeable with respect to the transaction involved, and the transaction is to be considered voluntary.<sup>164</sup> That is the extent of the guidance provided by the Regulations.

---

<sup>160</sup> *Id.* at 1340 (Carnes, J., dissenting).

<sup>161</sup> I.R.C. § 2032(a)(1)-(2) (2006).

<sup>162</sup> Treas. Reg. § 20.2031-1(b) (as amended in 1965).

<sup>163</sup> *Jelke*, 507 F.3d at 1331 (“We are dealing with hypothetical, not strategic, willing buyers and willing sellers.”); *Jameson v. Comm’r*, 267 F.3d 366, 372 (5th Cir. 2001) (“The hypothetical willing buyer/willing seller test substitutes evidence of the actual owner’s or purchaser’s intent with the most economically rational analysis of the sale.”); *Eisenberg v. Comm’r*, 155 F.3d 50, 57 (2nd Cir. 1998); *Estate of Bright v. Comm’r*, 658 F.2d 999, 1006 (5th Cir. 1984); *Estate of Andrews v. Comm’r*, 79 T.C. 938, 956 (1982) (“[T]he case law and regulations require a truly hypothetical willing seller and willing buyer. We must assume these hypothetical parties exist even though the reality of the situation may be that the stock will most probably be sold to a particular party or type of person.”); *LeFrak v. Comm’r*, 66 T.C.M. (CCH) 1297 (1993), 1993 WL 470956, at \*3 (“The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is not a personalized one which envisions a particular buyer and seller.”).

<sup>164</sup> Treas. Reg. § 20.2031-1(b) (as amended in 1965) (“[N]either being under any compulsion to buy or to sell and both having a reasonable knowledge of relevant facts.”); Treas. Reg. § 20.2031-3 (as amended in 1992) (containing the same language).

Determining the value of closely-held stock is, in the best of circumstances, an elusive task for any court.<sup>165</sup> When courts deviate from a valuation methodology that assumes a date-of-death liquidation and a fully discountable capital gains tax, they are heading into speculative territory. If a court presumes sales over time as the Tax Court did in *Jelke*, a number of variables become speculative, such as a turnover rate that is the same as the average turnover over the preceding “X” number of years, a turnover rate that is constant over a multi-year period despite the likely ups and downs of the market, a constant capital gains tax rate, future asset values which may be significantly higher or lower than actual, a presumed rate of return, a constant mix of investments over a multi-year period, and a continued corporate existence until the turnover reaches 100%.

Assumptions concerning these variables are more subjective and prone to error than a methodology that simply assumes liquidation at the date of death and computes and discounts for the amount of tax on any gains that would result. The latter methodology is clear and certain but admittedly rather arbitrary. Furthermore, the virtues of certainty, clarity, consistency, simplicity, and finality should not be denigrated. If there was a clearly more accurate and less arbitrary valuation methodology that required greater complexity and sophistication, of course that methodology should triumph in the pursuit of that discernable accuracy. That, however, is not the case.

The *Jelke* Tax Court and dissenting Court of Appeals Judge Carnes believed that the greater complexity and sophistication they advocated resulted in a more accurate valuation. That is a mistaken belief: It may be more accurate, but it also may not.<sup>166</sup> Absent the crystal ball Judge Carnes mocked or the revelations of time, no one can know which valuation (the Tax Court’s or the Eleventh Circuit’s) is more accurate. Either or both may be wildly or only slightly inaccurate. Since the

---

<sup>165</sup> See Stephen J. Leacock, *The Anatomy of Valuing Stock in Closely Held Corporations: Pursuing the Phantom of Objectivity into the New Millennium*, 2001 COLUM. BUS. L. REV. 161, 162-63 (2001).

<sup>166</sup> As stated by the Fifth Circuit in *Dunn* (requiring a dollar-for-dollar reduction for the built-in capital gains tax):

[V]aluing businesses, particularly closely held corporations, is not pure science replete with precise formulae and susceptible of mathematical calculation but instead depends largely on subjective opinions . . . [and] necessarily contain some vagaries, ambiguities, inexactitudes, caveats, and qualifications . . . the methodology we employ today may be viewed by some . . . as unsophisticated, dogmatic, overly simplistic, or just plain wrong . . . . In this regard, we observe that the end of the methodology spectrum opposite *oversimplification* lies *over-engineering*.

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

Regulations require the use of hypothetical buyers and sellers and since any method utilized may significantly under- or over-value closely held stock, it seems reasonable and prudent to presume liquidation as of the date of death, compute the capital gains tax at known current rates, and deduct the full amount of the tax from the liquidation amount. From there, discounts for lack of control and lack of marketability can be employed (two other *decidedly* imprecise measures).<sup>167</sup> As Revenue Ruling 59-60 indicated, the determination of the value of a closely held business is more art than science, and we must tolerate the reality that art is not subject to precise measurement.<sup>168</sup> It is indeed unfortunate that the Supreme Court

---

<sup>167</sup>The Internal Revenue Service defines a marketability discount as “[a]n amount or percentage deducted from an equity interest to reflect a lack of marketability” and a minority discount as “[t]he reduction, from the pro rata share of the value of the entire business, to reflect the absence of power or control.” Glossary, IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers (1997). The IRS Valuation Guide also says, “. . . Courts have allowed discounts ranging from 10 percent to 65 percent for marketability and minority interest.” *Id.* at 99. *See also* Leacock, *supra* note 165, at 196-200.

<sup>168</sup> Rev. Rul. 59-60, 1959-1 C.B. 237 (stating that “valuation is not an exact science”). Regarding securities, the Ruling states: “Valuation of securities is, in essence, a prophecy as to the future and must be based on facts available at the required date of appraisal.” *Id.* at § 3.03. Allowing a full discount for the tax on built-in gains would also arguably be more consistent with the Ruling’s injunction to be “based *on facts available at* the required date” rather than other methodologies which hypothesize discount rates and assume constants that, in fact, will change over time. *Id.* The Eleventh Circuit stated in *Jelke*:

Cases prior to the *Estate of Dunn*, prophesying as to when the assets will be sold and reducing the tax liability to present value, depending upon the length of time discerned by the court over which these taxes shall be paid, *require a crystal ball*. The longer the time, the lower the discount. The shorter the time, the higher the discount.

The downside of this approach is that, not only is it fluidly ethereal, *it requires a type of hunt-and-peck forecasting by the courts*. In reality, this method could cause the Commissioner to revive his “too speculative a tax” contentions made prior to the *Estate of Davis* in 1998. This methodology requires us to either *gaze into a crystal ball, flip a coin*, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other.

We think the approach set forth by the Fifth Circuit in the *Estate of Dunn* is the better of the two. The estate tax owed is calculated based upon a “snap shot of valuation” frozen on the date of Jelke’s death, *taking into account only those facts known on that date*. It is more logical and appropriate to value the shares of CCC stock on the date of death based upon an assumption that a liquidation has occurred, *without resort to present values or prophecies*.

The rationale of the Fifth Circuit in the *Estate of Dunn eliminates the crystal ball and the coin flip* and provides certainty and finality to valuation as best it can,

declined to hear the *Jelke* case because it could have provided a methodology that would result in consistency of application and greater uniformity of results in the valuation of closely held stock for estate and gift tax purposes.

## V. CONCLUSION

The *Jelke* case provided the United States Supreme Court an opportunity to clarify the law concerning the appropriate discount for capital gains taxes in the valuation of closely held stock for estate and gift tax purposes. *Jelke* was a “clean” case in that the overall value of the corporate assets was known and agreed upon by all parties.<sup>169</sup> Further, there was no dispute about the amount of the discounts for lack of control or marketability.<sup>170</sup> The Fifth and Eleventh Circuits have explicitly held that the full amount of the tax should be used in calculating the discount.<sup>171</sup> The Second and Sixth Circuits, however, have implied (but not definitively held) that something less than the full amount is more appropriate.<sup>172</sup> *Jelke* provided a ripe opportunity for the Supreme Court to rule on the issue, but the Supreme Court declined to do so for the time being. Cases concerning this topic will continue to percolate in the lower courts because the issue is significant and the amounts in controversy are often in the millions of dollars. The sooner the Supreme Court acts, the sooner this aspect of the valuation conundrum can be settled, and taxpayers and the Service can have clarity with regard to at least one component of this “vague and shadowy undertaking.”<sup>173</sup>

---

already a vague and shadowy undertaking. It is a welcome road map for those in the judiciary, not formally trained in the art of valuation.

*Jelke*, 507 F.3d at 1332-33 (emphasis added).

<sup>169</sup> *Jelke*, 507 F.3d at 1318 n.3.

<sup>170</sup> *Id.* at 1319 n.4.

<sup>171</sup> *Id.* at 1317; *Estate of Dunn v. Comm’r*, 301 F.3d 339 (5th Cir. 2002).

<sup>172</sup> *Estate of Welch v. Comm’r*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. Mar. 1, 2000); *Eisenberg v. Comm’r*, 155 F.3d 50 (2d Cir. 1998).

<sup>173</sup> *Jelke*, 507 F.3d at 1333.