Davis v. Commissioner, T.C. Memo. 1998-119

In valuing closely held stock for gift tax purposes, discounts for built-in capital gains tax are appropriately considered as part of a lack-of-marketability discount, even if liquidation or asset sale is not planned, because a hypothetical willing buyer and seller would consider these potential tax liabilities.

Summary

Artemus D. Davis gifted two blocks of 25 shares of A.D.D. Investment & Cattle Co. (ADDI&C) stock to his sons. The IRS determined a gift tax deficiency based on their valuation of the stock. ADDI&C was a closely held investment company holding a significant amount of Winn-Dixie stock. The Tax Court addressed the fair market value of the ADDI&C stock, focusing on discounts for blockage/SEC Rule 144 restrictions, minority interest, lack of marketability, and built-in capital gains tax. The court found that while no blockage discount was warranted, a discount for built-in capital gains tax was appropriate as part of the lack-of-marketability discount, even without planned liquidation, because a willing buyer would consider the potential tax liability. Ultimately, the court determined a fair market value lower than the IRS's but higher than the estate's initial valuation, incorporating discounts for minority interest and lack of marketability, including a component for built-in capital gains tax.

Facts

On November 2, 1992, Artemus D. Davis gifted two blocks of 25 shares each of ADDI&C common stock to his sons. ADDI&C was a closely held Florida corporation primarily a holding company, with assets including Winn-Dixie stock (1.328% of outstanding shares), D.D.I., Inc. stock, cattle operations, and other assets. ADDI&C and Davis were affiliates concerning Winn-Dixie stock sales under SEC Rule 144. ADDI&C had not paid dividends historically, except for a shareholder airplane use treated as a dividend in 1990. No liquidation plan existed on the valuation date.

Procedural History

The IRS determined a gift tax deficiency. Davis's estate petitioned the Tax Court to redetermine the fair market value of the gifted stock. Both the estate and the IRS modified their initial valuation positions during the proceedings.

Issue(s)

1. Whether a blockage and/or SEC rule 144 discount should be applied to the fair market value of ADDI&C's Winn-Dixie stock.
2. Whether a discount or adjustment attributable to ADDI&C's built-in capital gains tax should be applied in determining the fair market value of the ADDI&C stock.
3. If a discount for built-in capital gains tax is appropriate, whether it should be

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applied as a separate discount or as part of the lack-of-marketability discount, and in what amount.
4. What is the fair market value of each of the two 25-share blocks of ADDI&C common stock on November 2, 1992?

Holding

1. No, because the estate failed to prove that a blockage and/or SEC rule 144 discount was warranted on the rising market for Winn-Dixie stock and given the dribble-out sale method likely to be used.
2. Yes, because a hypothetical willing buyer and seller would consider the potential built-in capital gains tax liability, even without a planned liquidation.
3. As part of the lack-of-marketability discount, because it affects marketability even if liquidation is not planned. The court determined $9 million should be included in the lack-of-marketability discount for built-in capital gains tax.
4. The fair market value of each 25-share block of ADDI&C stock was $10,338,725, or $413,549 per share, reflecting discounts for minority interest and lack of marketability, including the built-in capital gains tax component.

Court's Reasoning

The court relied on the willing buyer-willing seller standard for valuation, considering all relevant factors. For unlisted stock, net worth, earning power, dividend capacity, and comparable company values are considered (Rev. Rul. 59-60). The court evaluated expert opinions, giving weight based on qualifications and analysis cogency.

Regarding the blockage discount, the court rejected it, finding that the rising trend of Winn-Dixie stock prices and the likely dribble-out sale method mitigated the need for such a discount. The court disagreed with expert Pratt's view of private placement sale and found Howard's Black-Scholes model unpersuasive for justifying a blockage discount in this context.

On built-in capital gains tax, the court rejected the IRS's argument that no discount is allowed if liquidation is speculative. The court distinguished prior cases, noting that in this case, all experts agreed a discount was necessary. The court emphasized that even without planned liquidation, the potential tax liability affects marketability and would be considered by hypothetical buyers and sellers. The court quoted Rev. Rul. 59-60, stating that adjusted net worth is more important than earnings or dividends for investment companies.

The court determined that a full discount for the entire built-in capital gains tax was not appropriate when liquidation was not planned. Instead, it followed experts Pratt and Thomson in including a portion of the built-in capital gains tax as part of the lack-of-marketability discount. The court found $9 million as a reasonable amount for this component within the lack-of-marketability discount.

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For the overall lack-of-marketability discount (excluding built-in gains tax), the court considered restricted stock and IPO studies, finding IPO studies more relevant for closely held stock like ADDI&C. The court criticized Thomson's limited consideration of IPO studies and his overemphasis on dividend capacity given ADDI&C's history. Weighing expert opinions and relevant factors, the court determined a $19 million lack-of-marketability discount (excluding built-in gains tax), resulting in a total lack-of-marketability discount of $28 million (including the $9 million for built-in gains tax).

Practical Implications

Davis clarifies that built-in capital gains tax is a relevant factor in valuing closely held stock even when liquidation is not planned. It emphasizes that the hypothetical willing buyer and seller would consider this potential future tax liability, impacting marketability. This case supports the inclusion of a discount for built-in capital gains tax, particularly as part of the lack-of-marketability discount, in estate and gift tax valuations of closely held investment companies. It highlights the importance of expert testimony in valuation cases and the court's discretion in weighing different valuation methods and expert opinions. Subsequent cases will likely cite *Davis* to support discounts for built-in capital gains tax even in the absence of imminent liquidation, focusing on the impact on marketability and the hypothetical buyer-seller perspective. This case reinforces that valuation is fact-specific and requires a holistic analysis considering all relevant discounts and adjustments.

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