Estate of Artemus D. Davis, Deceased, Robert D. Davis, Personal Representative v. Commissioner of Internal Revenue, 110 T. C. 530 (1998)

A built-in capital gains tax should be considered in determining the fair market value of stock, even if no liquidation is contemplated, as part of the lack-of-marketability discount.

Summary

In Estate of Davis v. Commissioner, the Tax Court addressed the valuation of two blocks of stock in a closely held investment company, ADDI&C, given as gifts by Artemus D. Davis to his sons. The key issue was whether to apply a discount for the built-in capital gains tax when calculating the stock's fair market value, given that no liquidation was planned. The court ruled that, despite no planned liquidation, a discount for the built-in capital gains tax was warranted as part of the lack-of-marketability discount, as it would impact the hypothetical willing buyer and seller's agreement on the stock's price. The court determined the fair market value of each block of stock to be $10,338,725, reflecting a minority and lack-of-marketability discount, including $9 million attributed to the built-in capital gains tax.

Facts

On November 2, 1992, Artemus D. Davis, a founder of Winn-Dixie Stores, gifted two blocks of 25 shares each of ADDI&C common stock to his sons, Robert and Lee Davis. ADDI&C was a closely held Florida corporation, primarily a holding company for various assets, including a significant holding in Winn-Dixie stock. Each block represented 25. 77% of ADDI&C's issued and outstanding stock. The valuation of these blocks was contested, with the estate arguing for a discount due to the built-in capital gains tax on ADDI&C's assets, while the Commissioner argued against such a discount.

Procedural History

The estate filed a Federal gift tax return in 1993, valuing each block of stock at $7,444,250. The Commissioner issued a notice of deficiency, asserting a higher valuation of $12,046,975 per block. The estate petitioned the U. S. Tax Court for a redetermination of the deficiency, modifying its position to value each block at $6,904,886, while the Commissioner also modified its position to $13,518,500 per block. The Tax Court, after considering expert testimony and evidence, issued its decision on June 30, 1998.

Issue(s)

1. 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 each block of ADDI&C stock on the valuation date?

2. If such a discount is warranted, should it be applied as a reduction to ADDI&C's net asset value before applying minority and lack-of-marketability discounts, or should it be included as part of the lack-of-marketability discount?

Holding

1. Yes, because a hypothetical willing buyer and seller would consider the built-in capital gains tax in negotiating the price of the stock, even though no liquidation was planned.

2. No, because the full amount of the built-in capital gains tax should not be applied as a direct reduction to ADDI&C's net asset value; instead, it should be included as part of the lack-of-marketability discount.

Court's Reasoning

The Tax Court applied the willing buyer and willing seller standard for determining fair market value, emphasizing that both parties would consider the built-in capital gains tax in their negotiations, even without a planned liquidation. The court rejected the Commissioner's argument that such a tax could be avoided through tax planning, such as converting ADDI&C to an S corporation, as this was considered unlikely. The court also found that the full amount of the built-in capital gains tax should not be deducted directly from ADDI&C's net asset value, as this approach would not reflect the market's perception of the stock's value. Instead, the court agreed with experts from both sides that a portion of the built-in capital gains tax should be included as part of the lack-of-marketability discount, reflecting the reduced marketability of the stock due to this tax liability. The court ultimately determined a $9 million portion of the lack-of-marketability discount should be attributed to the built-in capital gains tax.

Practical Implications

This decision has significant implications for the valuation of closely held stock, particularly in cases where built-in capital gains tax is a factor. It establishes that such a tax should be considered in determining fair market value, even absent a planned liquidation, by including it in the lack-of-marketability discount. This ruling affects how similar cases should be analyzed, requiring appraisers and courts to consider the impact of built-in capital gains tax on stock valuation. It also influences legal practice by emphasizing the importance of expert testimony and market-based approaches in valuation disputes. For businesses, this decision may affect estate planning and gift tax strategies involving closely held stock. Subsequent cases have applied this ruling, further solidifying its impact on tax and valuation law.

