

February/March 2004 — Trapped-In Capital Gains by Larry Grant, ASA

An ongoing issue in gift and estate tax valuations is whether, or the extent to which, the liability for unrealized capital gains on appreciated assets should be reflected in valuations of the stock or partnership that owns those assets.

Until 1998, the IRS and the U. S. Tax Court vigorously held that the trapped-in capital gains were not a basis for a discount.

In my opinion and in the opinion of many other business appraisers, the liability for trapped-in capital gains should be reflected in the valuation of the stock. In the real world, prudent purchasers and knowledgeable sellers recognize the liability for taxes and act according in the purchase and sale of stock.

Our appraisal firm has completed another assignment with respect to capital gain issues.

In this engagement, the Decedent held 100% of the outstanding stock of a closely held C-corporation. The corporation in turn held a 65% fractional interest in the real property upon which the corporation conducted a business.

First, we calculated and deducted what we felt was the first segment of a Discount for Lack of Marketability, exclusive of capital gain issues. We then calculated and deducted the second segment of the Discount for Lack of Marketability incorporating the capital gain liability.

A summary of certain calculations similar to those we made, and the rationale for these calculations, follow:

First Segment of the Lack of Marketability Discount

Market Value of the Real Property on a 100% Ownership Basis	<u>\$3,600,000</u>
The Corporation's 65% Proportionate or Pro Rata Share (65% X \$3,600,000)	\$2,340,000
Less a 10% Discount for Lack of Marketability	<u>(234,000)</u>
Market Value of the Corporation's 65% Fractional Interest in the Real Property (1)	<u>\$2,106,000</u>

Second Segment of the Lack of Marketability Discount

Now with respect to the appropriate discount for the built-in or trapped-in capital gain taxes:

We concluded that the present value of the capital gain tax liability (calculated from the time the Corporation is forecasted to be sold some seven years in the future, brought back to the date of appraisal) is a direct deduction from the Fair Market Value.

The Corporation's estimated capital gain tax liability as of June 30, 2007 is calculated next, and the present value of that tax is computed as follows:

Corporation's Tax Basis as of June 30, 2000 (1)	\$250,000
Corporation's Estimated Tax Basis at June 30, 2007 (2)	\$320,000
Fair Market Value of the Corporation as of June 30, 2000 "Before" Capital Gain Consideration (3)	\$2,400,000
Fair Market Value of the Corporation Estimated at June 30, 2007 (4)	\$3,072,000
Estimated Capital Gain at June 30, 2007 (5)	\$2,752,000
Total Tax on Capital Gain or Capital Tax Liability (6)	\$630,300
Present Value at June 30, 2000 of the Capital Tax Liability estimated to accrue through June 30, 2007 (7)	<u>\$294,000</u>

Conclusion & Calculation of the Total Discount for Lack of Marketability

Calculated on the basis of the Market Value of the Fractional Interest:

First Segment	\$234,000
Second Segment	<u>294,000</u>
Total Marketability Discount	<u>\$528,000</u>

1. On the Real Property Value:

As a Percentage: \$528,000 divided by \$2,340,000 = 26.0%

2. On the Value of the Outstanding Stock Before Discount:

Percentage: \$528,000 divided by (\$2,400,000 + \$234,000, or \$2,634,000) = 20.0%

(1) The sum of the Corporation's capital contributions and the par value of its shares as reported in its most recent U. S. Corporation Income Tax Return prepared prior to the effective date of value.

(2) Assuming a 4% annual increase to the June 30, 2000 basis for 7 years: \$250,000 X 4% for 7 years on a straight-line or simple interest growth. In determining the 4% annual increase, we considered the CPI increases over the last three years of approximately 2% per annum and adding an estimated 2% real growth factor.

(3) The sum of the following:

Real property	\$2,106,000
F, F & E	25,000
Net Tangible Assets other than Real Property & F, F&E	144,000
Goodwill & Other Intangibles	<u>125,000</u>
Total	<u>\$2,400,000</u>

(4) Again, assuming a 4% annual increase for the June 30, 2000 value for 7 years: \$2,400,000 X 4% for 7 years. In determining the 4% annual increase, we again considered the CPI increases over the last three years of approximately 2% per annum and adding an estimated 2% real growth factor.

(5) \$3,072,000 estimated value in the future minus the \$320,000 future basis = \$2,752,000.

(6) Calculated as follows:

Future capital gain	\$2,752,000
Less California Franchise Tax Rate of 9.3% on capital gain as determined by the Corporation's outside CPA	<u>(255,936)</u>
<u>Balance subject to Federal Tax</u>	<u>\$2,496,064</u>
Federal Tax Rate of 15% on capital gain as determined by Corporation's CPA	<u>(374,410)</u>
Total, California Franchise Taxes & Federal Taxes on Capital Gain	<u>\$ 630,346</u>
Rounded,	\$ 630,300

(7) Present value of \$630,300 discounted for 7 years back to June 30, 2000, at a discount rate of 11-1/2% = \$294,187. Rounded, \$294,000. The

discount rate is based on rates of return prevalent at that time for relatively safe investments plus an incremental risk rate factor.

Example: U. S. Treasury Securities, 7-year notes with a return of 6.52% plus 5% to encompass the related risks on investment that may arise during the forecasted 7 year investment period – that a prudent investor would require.