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Estate Tax Decision Upholds Full Capital Gains Discount

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An important aspect of estate planning is taking advantage of valuation discounts. One such discount is the so-called "capital gains discount," which provides a reduction in the value of closely-held "C" corporation stock held by an estate. The capital gains discount is based on the fact that taxable gain will inevitably be recognized when the corporation sells its appreciated assets or liquidates. Thus, the stock of the corporation is treated as being less valuable to account for the built-in tax liability of the assets held by the corporation.

Under current law, the courts are split as to whether the capital gains discount should reduce the value of corporate stock held by an estate by the full contingent tax liability of the assets of the corporation (the "full approach"), or rather by a reduced amount computed by a formula that takes into account an estimated time frame for when the corporation will actually recognize the built-in tax liability (the "reduced approach"). Thus, the capital gains discount and the overall value of the estate will vary depending on which approach is adopted by the jurisdiction governing the estate.

Until recently, only the Fifth Circuit (which includes Mississippi, Louisiana and Texas) followed the full approach. The Eleventh Circuit (which encompasses, Alabama, Georgia and Florida) has joined the Fifth Circuit by adopting the full approach for estate tax purposes in *F. Jelke III v. Comm'r (Jelke III)*. *Jelke III* involved a decedent taxpayer who held a 6.44 percent stock interest in a closely-held investment holding company during his lifetime. In computing the value of the decedent's stock for estate tax purposes, his estate reduced the company's net asset value by the amount of tax liability that would have been realized by the company at the corporate level if it had liquidated at the decedent's death. This reduction discounted the corporation's value by $51 million dollars. The IRS alleged that the estate undervalued the decedent's 6.44 percent interest in the company and allowed only a portion of the discount for the built-in tax liability. The IRS's position was that the full deduction should not be allowed because the corporation would not actually recognize the tax liability for a number of years. The United States Tax Court accepted the IRS's contention and allowed only a limited deduction of $21 million dollars.

The Eleventh Circuit, however, was not persuaded by the position taken by the IRS or the United States Tax Court, noting "[i]t is more logical and appropriate to value the shares of [the corporation's] stock on the date of death based on an assumption that a liquidation has occurred, without resort to present values or prophesies." The Court found in favor of the decedent's estate and allowed the full capital gains discount. The Court opined that other approaches were too speculative and required a "crystal ball and coin flip."

The decision of the Eleventh Circuit was not unanimous, and a spirited dissent noted that "To avoid the effort, labor, and toil that is required for a more accurate calculation of the estate tax due, the majority simply assumes a result that we all know is wrong." Quoting such sources as Theodore Roosevelt and Henry James, the dissent described the majority's approach as "the doctrine of ignoble ease."

The decision is an important one for the estates of decedents who, at their death, held interests in closely-held C corporations with appreciated assets. The *Jelke* decision means that estates which fall under the jurisdiction of the Fifth and Eleventh Circuits should be entitled to a full capital gains discount, undiminished by statistical estimation of when the tax will actually be paid by the corporation. But it remains to be seen whether the IRS will acquiesce with the *Jelke* majority or will side with the dissent in the belief that the full deduction is "a result that we all know is wrong."