Considerations of the Built-In Gain (BIG) Tax Liability Discount During the S Corporation Conversion Recognition Period

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In performing a valuation analysis of an S corporation during the 10-year time period after its conversion from a C corporation, it is appropriate to apply a valuation adjustment (or discount) in so far as any built-in capital gain remains that will be subject to a C corporation tax liability upon disposition. There are a number of factors the valuation analyst may consider in determining an appropriate valuation discount.

Introduction

For C corporations that meet the eligibility criteria for S corporation income tax status, electing to convert to an S corporation (the "election" or the "conversion") results in the company enjoying, from the date of conversion, tax efficiencies from the following:

1. Income from operations
2. Income from the disposition of the business and/or assets

These tax efficiencies, or the "pass-through" nature of the S corporation, represent the singular economic motivation for conversion.

Income generated from the operations of the company are no longer taxable at the corporate level and are "passed-through" to the shareholders who pay taxes at their respective individual tax rates. Similarly, any businesses and/or assets acquired by the S corporation, from the date of conversion and afterwards, and subsequently sold for a gain, also enjoy this pass-through economic benefit at the corporate level.

The only instance where corporate level taxes are applicable to an S corporation, as if it were a C corporation, is when assets owned at the time of the S corporation conversion election are subsequently sold within the 10-year time period after its conversion from a C corporation. This 10-year period is often referred to as the "recognition period."[1]

At the time of the election, all the assets of the company will be valued at their fair market value. The difference between the fair market value and the historical cost basis, or income tax basis, of the company's assets represent an unrealized built-in capital gain (BIG).

If the S corporation subsequently sells any of these assets, a BIG will be realized and the company will be liable to pay corporate level taxes on the gain as if it were a C corporation. If, however, the S corporation does not sell these assets until after the recognition period, the gains will no longer be taxable to the S corporation.

This discussion considers the following topics:

1. The eligibility criteria for S corporations
2. A review of Tax Court cases dealing with determining C corporation BIG tax liability discounts
3. A review of the Tax Court case *Estate of Litchfield v. Commissioner*, which deals with the S corporation BIG tax liability valuation discount
4. The approaches to consider in estimating the S corporation BIG tax liability discount during the recognition period

Eligibility Criteria for S Corporations

C corporations converting to S corporations must satisfy five statutory requirements pursuant to Internal Revenue Code Section 1361 and the related Regulations. These requirements are listed as follows:

1. The company must be a domestic corporation.
2. The company must have shareholders that consist only of individuals, certain trusts, and estates. Nonqualified shareholders include partnerships, corporations, and foreign individuals or entities.
3. The company must have no more than 100 shareholders.
4. The company must have only one class of stock, although the stock can be differentiated with voting and nonvoting characteristics. Furthermore, distributions and liquidations to shareholders must be conducted on a pro rata basis.
5. The company must not be an ineligible corporation, including certain financial institutions, insurance companies, and domestic international sales corporations.

Given these criteria, many companies are precluded from converting to an S corporation. Furthermore, these criteria reduce the number of potential candidates to acquire an S corporation without losing the valuable tax efficiencies accrued by its S corporation status.

Court Cases Dealing with C Corporation Built-In Capital Gains

After the repeal of the *General Utilities* doctrine by the enactment of the *Tax Reform Act of 1986* (the "Tax Reform Act"), a company acquiring the equity of another company, for income tax purposes, must carry forward the assets of the acquired company at their historical cost basis and not their "stepped-up" basis.

To the extent the fair market value of the assets are greater than their historical costs, this treatment creates a potential unrealized built-in capital gain tax obligation which would be due upon the disposition of the assets.

Acquirers of companies would discount the purchase consideration by some amount based on the perception of the unrealized built-in capital gain tax liability which the acquirer may realize and pay in the future. Quantifying the amount of the discount has been the topic of much debate and litigation in the years since the enactment of the Tax Reform Act.

The first court case which recognized a BIG liability discount was the *Estate of Davis*[2] filed in 1998. Here, the two valuation analysts of the taxpayer and the valuation analyst of the Internal Revenue Service ("Service") both agreed that a willing buyer and a willing seller would have considered the BIG tax liability in arriving at a purchase price for the stock.

The Tax Court found that approximately $9 million (or 34 percent) of the total built-in tax liability of $26.7 million was appropriate to include as the discount. The Tax Court added that the total BIG tax liability should not be taken. This is because no evidence was introduced to prove that the C corporation planned to liquidate or sell any of its appreciated assets.

On the other side of the spectrum, in both the *Estate of Dunn*[3] case and the *Estate of Jelke*[4] case, the respective appeals courts ruled that 100 percent of the BIG tax liability should be discounted in calculating the net asset value. These judicial decisions were made without any consideration for whether the assets subject to the BIG tax liability would ever be sold or liquidated.

Court Case Dealing with S Corporation Conversion Built-In Capital Gains

The *Estate of Litchfield*[5] case represented a departure from the judicial rulings on the *Dunn* and *Jelke* cases. In *Litchfield*, the valuation analysis could not reasonably ignore consideration for whether the assets subject to the BIG tax liability would ever be sold or liquidated. This is because the subject company of Litchfield had converted from a C corporation to an S corporation approximately 16 months prior to the valuation date.

In considering the BIG tax liability for a C corporation, the argument is made that the unrealized tax liability will always exist and, at some point, it will ultimately be realized and trigger the tax liability on the BIG.

However, in considering the BIG tax liability for an S corporation conversion, this argument does not hold because at the end of the 10-year recognition period the BIG tax liability expires.

"... the asset turnover assumption is central to arriving at a reasonable, demonstrable, and defensible determination of the BIG discount."

In determining the discount, the estate's valuation analyst performed the following procedures:

1. Reviewed historic asset sales with consideration for more recent sales
2. Reviewed board meeting minutes
3. Held discussions with management about their plans for future sales of the assets
4. Estimated the asset appreciation over a projected holding period

In contrast, the Service only reviewed historical asset sales over a long time horizon and did not consider recent sales differently than the more dated historical sales. The court adopted the estate valuation analyst's discount for the BIG tax liability without adjustment.

Procedures to Consider in Determining the Built-In-Gain Tax Liability Discount

As is the case in all valuation analyses, the idiosyncrasies of the subject company and the subject analysis—the facts and circumstances—will dictate the procedures that the valuation analyst will use and ultimately rely on.

The following discussion reviews one example of an empirical market analysis method as well as a number of company-specific considerations the analyst may use in determining the valuation discount for the BIG tax liability (the "BIG discount").

Market Studies

Depending on the industry, there may be publicly traded companies that have corporate structures that are taxable at the corporate level (i.e., subject to double taxation) and other comparable companies with corporate structures that are not taxable (i.e., pass-through) at the corporate level.

One common example is real estate companies, where one form of corporate structure is a C corporation subject to double taxation and the other is a real estate investment trust (REIT), which is a pass-through entity that avoids the double taxation experienced by real estate C corporations.

Comparisons can be made between a REIT's net asset value (NAV) as determined by appraised asset values and its publicly traded price. The resulting differences, or discounts, are understood to be attributed to the lack of control of public owners. A similar comparison can be made between a publicly traded C corporation's NAV and its market price.

Some analysts have found the results of these comparisons to indicate valuation discounts of C corporations to be higher than that of REITs. This is because the discounts for C corporations are understood to be attributed to the following factors:

1. A discount for lack of control
2. A discount for the profits of the company that are lost to taxation

Therefore, the discount attributable to corporate level taxation can be isolated by backing out the observed discounts from REITs from the observed discounts from C corporations.[6]

While this method, and all market approach valuation methods, offers important third-party market-based data, it may lack enough comparability with the subject company to be reliable. Ultimately, the valuation analyst will assess how much this method is weighted, if at all, in arriving at a suitable BIG discount determination.

Asset Turnover

The favorable judgment that the estate's valuation analyst enjoyed in the *Litchfield* case provides important judicial guidance that the valuation analyst may consider in determining the BIG discount. Clearly, the asset turnover assumption is central to arriving at a reasonable, demonstrable, and defensible determination of the BIG discount.

The following considerations relate to asset turnover that may be made in determining an appropriate BIG discount:

1. A company that routinely sells all of its assets several times a year. All other variables held constant, this may result in selecting a high BIG discount.
2. A company that maintains a buy-and-hold strategy for its assets. All other variables held constant, this may result in selecting a low BIG discount.
3. Understanding asset turnover by asset type vis-à-vis those assets subject to the BIG tax liability. If asset turnover is specific to a certain type of asset at the subject company, then the historical analysis should necessarily be performed for each asset

type and compared to the specific assets subject to the BIG tax liability.

4. Examination of historical asset turnover by time period. If the level of asset turnover changes over time, then it is important to examine (a) the time periods and their duration, (b) the levels of turnover and their duration, (c) what were the conditions at the company and in the market place during these time periods that contributed to the changing turnover rates, and finally (d) how do these findings compare to the current circumstances.

5. Examination of the historical asset turnover from the conversion date to the valuation date. If asset turnover levels have changed overall or related to the subject assets of the BIG tax liability over this period, consideration of this change is important.

6. Examination of historical sales of assets, both those subject to the BIG tax liability and those not subject to the BIG tax liability, that were rolled over into new investments. By rolling sale proceeds into new investments, any gain associated with the sale may be deferred if the new investment qualifies under the election of a Section 1031 or 1033 exchange.

   In the case of BIG tax liabilities for S corporations, if the deferral goes past the recognition period, the BIG tax liability is then avoided altogether.

The Recognition Period Point in Time

Another important consideration in determining a BIG discount is how far along in the recognition period is the valuation date of the subject analysis. If the valuation date is on the first day of the recognition period—that is, on the conversion date—the procedure may be similar to determining the BIG discount for C corporations.

Discounting the whole liability may be a reasonable position based on some of the judicial cases, such as *Dunn* and *Jelke*.

However, if the valuation date is on the last day of the recognition period, a more reasonable position would be to not assign any BIG discount. Thus, the selection range of BIG discounts is quite wide—from 100 percent to zero percent and generally declines over time, all other variables held constant.

It is also noteworthy that, all other variables held constant, the rate of decline from 100 percent to zero percent as time passes along the recognition period is not likely to be a straight line. It is more likely to decline at an accelerated rate as the "relief" from the BIG tax liability increases at an accelerated rate as time approaches the end of the recognition period.

". . . if asset values have changed since the conversion, this will impact the determination of the BIG discount."

Management Discussions

The valuation analyst should also conduct discussions with management regarding their perspective and plans for growing the company and managing risks.

These management discussions should include the following factors:

1. Historical asset turnover described above
2. Management's plans for asset retention or disposition
3. Management's business, market, and economic outlook
4. An overall assessment of how the plan is consistent, or not, with these points

The valuation analyst may also request and review the subject company's board minutes to further understand and examine the current position of the company, its strategy and outlook.

Net Present Value

To the extent asset sales can be projected over time, the BIG tax liabilities that are triggered should be discounted back to the present value as of the valuation date in order to determine the BIG discount.

Current Value versus Conversion Value

The BIG tax liability is also affected by the current value of the remaining assets subject to the BIG tax compared to the original BIG tax liability established at the conversion date. In other words, if asset values have changed since the conversion, this will impact the determination of the BIG discount.

Exhibit 1 illustrates four scenarios to examine here—two scenarios reflect asset value declines since conversion and two scenarios reflect asset value appreciation since conversion.

These Exhibit 1 scenarios are as follows:

Exhibit 1
S Corporation Built-In Capital Gain and Tax Liability Calculations at Conversion and Valuation Dates

	At the S Corporation Conversion Date			At the Valuation Date						
Scenario	C Corp Income Tax Basis	S Corp Conversion Date FMV	S Corp Unrealized BIG	S Corp Valuation Date FMV	C Corp Unrealized Adjusted BIG	S Corp [1] Unrealized Adjusted BIG	C Corp BIG Tax Liability	S Corp BIG Tax Liability	S Corp BIG Expiration	After-Tax Net Gain to Company
Formulas:	a	b	c=b-a	d	e=d-a	f=min of e,c	g=e*40%	h=f*40%	i=c-f	j=e-h
1	$25	$100	$75	$45	$20	$20	$8	$8	$55	$12
2	$25	$100	$75	$25	$0	$0	$0	$0	$75	$0
3	$25	$100	$75	$105	$80	$75	$32	$30	$0	$50
4	$25	$100	$75	$150	$125	$75	$50	$30	$0	$95

Note:
[1] Any appreciation after the conversion date is not subject to taxation, thus the maximum BIG for the company will be $75 established at the time of the conversion.

1. A moderate decline in the subject assets' value—in the instance the assets subject to the BIG tax have declined but remain greater than their income tax basis, the BIG discount is expected to decline as well. For example, if, at the conversion date, the income tax basis for a single asset is $25 and the current value of the asset $100, an unrealized BIG of $75 is established.

   If the value of the asset at the valuation date declined to $45 and market expectations do not include a recovery over the remainder of the recognition period, then the unrealized BIG essentially declines to $20. If the asset is expected to be sold at this lower level, then the realized BIG subject to the BIG tax liability is $20 and $55 of the BIG expires. This results in a decline in the BIG discount.

2. A steep decline in the subject assets' value—in the instance the assets subject to the BIG tax have declined to a level at or below their income tax basis, the BIG discount should be zero.

   To continue the example above, if the value of the asset at the valuation date declined to $25 and market expectations do not include a recovery over the remainder of the recognition period, then the unrealized BIG declines to $0.

   If the asset is expected to be sold at this lower level, then the realized BIG subject to the BIG tax liability is realized at $0 and $75 of the BIG expires. This results in no BIG discount.

3. A moderate increase in the subject assets' value—in the instance the assets subject to the BIG tax have appreciated moderately, the BIG discount should reflect the full BIG tax liability.

   In the same example above, if the value of the asset at the valuation date increased to $105 and market expectations do not include a change from this level for the remainder of the recognition period, then the unrealized BIG remains at $75.

   Note here that the unrealized built-in gain does not increase to $80.[7] If the asset is expected to be sold at this level, then the BIG discount should reflect the full BIG tax liability related to the BIG of $75. Note also that the net gain to the company will be less than $75 because of the BIG tax liability. At a 40 percent corporate tax rate, this results in a net gain to the company of $50.

4. A sharp increase in the subject asset values—in the instance the assets subject to the BIG tax have appreciated sharply, the BIG discount should also reflect the full BIG tax liability.

   To continue the example, if the value of the asset at the valuation date increased to $150 and market expectations do not include a change from this level for the remainder of the recognition period, the unrealized BIG also remains at $75.

   In this instance also, the unrealized BIG does not increase based on the current value of the asset. If the asset is expected to be sold at this level, the BIG discount

should reflect the full BIG tax liability related to the BIG of $75.

Note in this case that the net gain to the company will be greater than $75 because of the sharp increase in the subject asset's value compared to the realized BIG tax liability. At the 40 percent corporate tax rate, this results in a net gain to the company of $95.

In both scenarios 3 and 4, assuming the assets are sold at their respective levels, the BIG discount would reflect the full BIG tax liability. The difference between these two scenarios relates to the likelihood that management would sell the asset.

All other variables held constant, the likelihood of a sale in scenario 4 is greater than in scenario 3. Current market conditions and expectations for future market conditions will affect the valuation analyst's determination of the BIG discount.

Summary and Conclusion

The determination of BIG discounts for S corporation conversions differs from C corporations due to the expiration of the BIG at the end of the recognition period.

In C corporation cases, some courts have considered in their opinion whether or not the subject company would ever sell or liquidate their assets triggering the BIG. Consequently, these courts have accepted a discount of less than 100 percent of the BIG tax liability.

Other courts have opined that triggering the BIG was not relevant and have granted the full BIG tax liability as the discount.

Important procedures that the valuation analyst may consider in determining the BIG discount include the following:

1. Explore market studies, where available, that compare publicly traded C corporations with publicly traded pass-through entities to isolate the difference due to corporate taxation.
2. Examine historical asset turnover statistics both prior to conversion and from the conversion date to the valuation date.
3. Determine how far along in the recognition period is the subject analysis.
4. Hold management discussions and review relevant corporate documents such as board meeting minutes.
5. Present value BIG tax liabilities generated from projected asset sales.
6. Assess the current value of the assets subject to the BIG tax compared to the asset values at the time of the conversion.

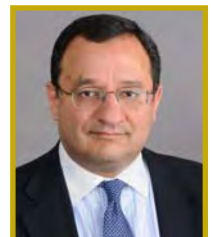
"The final procedure in concluding the BIG discount is to ensure that the conclusion is internally consistent with all the empirical and company-specific data that has been compiled."

The final procedure in concluding the BIG discount is to ensure that the conclusion is internally consistent with all the empirical and company-specific data that has been compiled. It is just as important to provide an explanation of why some of the data is not internally consistent, as it is to explain why reliance was placed on some of the data while none was placed on other data.

The more thoughtful and supportable an analysis is, the more positively it will be received by the courts. This is evidenced by the commentaries in the opinions set forth by the courts, as in the *Litchfield* case.

Notes:

1. In recent years, the recognition period has changed from ten years. In 2009 and 2010, it changed to seven years. In 2011 to 2013, it changed to five years. See Section 1374(d)(7)(B) and 1374(d)(7)(C).
2. Estate of Davis v. Comm'r, 110 T.C. 530 (1998).
3. Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2001).
4. Estate of Jelke v. Comm'r, 507 F.3d 1317 (11th Cir. 2007).
5. Estate of Litchfield v. Comm'r, T.C. Memo. 2009-21 (January 29, 2009).
6. Note that the calculation to arrive at the discount for the C corporation double taxation is not a simple subtraction, since the two discounts are sequential.
7. Section 1374(d)(3)(B). Also, see Garwood Irrigation Co. v. Comm'r, 88 TCM (CCH) 173 (2004).



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