

# ***Estate of Jelke is a poor decision for taxpayer***

*Estate of Jelke*,<sup>1</sup> a C corp holding a portfolio of stocks, had these issues before the Tax Court:

1. Amount of discount for trapped-in capital gains
2. Amount of discount for lack of control
3. Amount of discount for lack of marketability

(See *BVU* August 2005, p. 8 for details.)

## **Trapped-in capital gains**

**Will Frazier**, expert for the estate, testified to a dollar-for-dollar discount for trapped-in capital gains. The IRS expert testified to a present value analysis based on estimated time of sale of the underlying securities at a 13.2 percent annualized discount rate, with no appreciation in the stocks. Unfortunately, **Judge Gerber** went entirely with the IRS expert.

The consensus among business appraisers is that the dollar-for-dollar amount of the tax should be deducted from the results of an asset approach to valuation.<sup>2</sup> I always show the federal tax liability against my stocks or my financial statement, in accordance with AICPA directives.

## **Even if discounted, rate too high**

Judge Gerber noted in his opinion that Frazier did not give adequate economic support for his position in his report. But Frazier attached an article explaining the rationale as an addendum to his report. Perhaps Judge Gerber did not read that addendum.

In any case, *even when a court does decide that the liability should be discounted*, it should not be discounted at an equity rate as it was in *Jelke*. It is not a matter of whether, but when the liability will be paid. Since it is a liability to the Federal government, it should probably be discounted at the risk-free rate. At *most*, it should be discounted at the company's borrowing rate, since it is a debt.

## **Minority discount hard to quantify**

As Judge Gerber correctly stated, "It is difficult to quantify the discount for lack of control." The estate claimed a 25 percent discount for lack of control; The IRS claimed five percent.

The court concluded a discount of 10 percent for lack of control.

The estate claimed a 35 percent discount for lack of marketability based on restricted stock studies. The IRS claimed 10 percent based on analysis of the *Mandelbaum*<sup>3</sup> factors, *but without specifying the base from which the discount was being subtracted*.

## **Court accepts Mandelbaum factors**

Judge Gerber adopted the Mandelbaum procedure but made some adjustments to the IRS' analysis. The court concluded a 15 percent DLOM, lower than the "average," again not specifying what the "average" was or on what it was based.

When Judge Laro first enumerated the factors in the original *Mandelbaum* case in 1995, he specified that the starting point was the 35 percent average of the restricted stock studies and the 45 percent average of the pre-IPO studies, concluding a 30 percent DLOM. Apparently, Judge Gerber simply accepted the IRS' 20 percent "average discount" starting point with no source given.

## **Conclusion**

My "gut feel" is that the DLOM is quite a bit too low for a minority interest in a privately held securities holding company, especially one that pays out only about three percent of the NAV. Also, the DLOM is not supported in the opinion because the basis for the starting point from which, on balance, the analyzed factors are deemed to lower the DLOM, is not specified.

I believe that the taxpayer was ill served by the decision, at least in terms of the discount for trapped-in capital gains and the DLOM.

<sup>1</sup> Estate of Jelke v. Commissioner, T.C. Memo 2005-131, 2005 Tax Ct. Memo LEXIS 128 (May 31, 2005).

<sup>2</sup> See, for example, Christopher Z. Mercer, "Embedded Capital Gains in C Corporation Holding Companies," *Valuation Strategies*, November/December 1998, pp. 30-41; John Gilbert, "Built-in Gain Valuation Adjustment: No Longer 'If' But 'How' and 'How Much,'" *CPA Expert*, Winter 1999; and Shannon P. Pratt, "Discounts for Trapped-In Capital Gains Taxes," chap. 14 in *Business Valuation Discounts and Premiums*, (Hoboken, NJ: John Wiley & Sons, 2001).

<sup>3</sup> *Mandelbaum v. Comm'r*, T.C. Memo 1995-255 (1995) aff'd 91 F.3d 124 (1996).

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