Estate of Frazier Jelke – Value of Imbedded Capital Gains
A Major Win For Taxpayers

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On November 15, 2007 the 11th Circuit Court of Appeals made big news when it overturned a high profile trial court decision in *Estate of Jelke v. Commissioner (05-15549)*. The Jelke case is the latest in the evolving question of how to handle built-in capital gains tax liability when valuing a business.

The business in this matter was a C corporation that, at the date of Mr. Jelke's death, owned marketable securities investments totaling $188 Million. The stock portfolio was comprised of 92% blue chip domestic equities and 8% international equities. The corporation had a relatively high annual rate of return (23%) for the five years prior to the valuation date. The unrealized capital gains as of the date of death (valuation date) was $51 million.

When the estate tax return was filed the corporation was valued by the estate by subtracting the entire $51 million contingent capital gains tax liability. The IRS issued a deficiency notice using a zero discount for built-in gains tax. At trial the IRS modified their position allowing for a partial $21 million discount for the built-in capital gains tax liability discounted to reflect present value on the valuation date based on when assets would likely be sold. The likely sale dates were projected based on the historical turnover of investments in the portfolio – 16 years.

In 2005 the trial court sided with the trial position of the IRS. The appeals court reversed that decision and agreed with the position of the taxpayer. The appeals court opinion (along with a dissenting opinion) stretches over 53 pages and can be obtained from http://www.ca11.uscourts.gov/opinions/ops/200515549.pdf.

The opinion presents a comprehensive and succinct summary of the legislative, regulatory, and judicial history of the valuation issues related to built-in capital gains. After analysis in light of that history, the conclusion was that the trial court verdict was vacated and remanded with instructions that it recalculate the net asset value using a "dollar-for-dollar reduction of the entire $51 million built-in capital gains tax liability … under the arbitrary assumption that (the company) is liquidated on the date of death and all assets sold."

The rationale for the decision was as follows:

- This opinion is in accord with the "simple yet logical" analysis and conclusion reached by the 5th Circuit in a similar case - *Estate of Dunn*, 301 F.3d at 350-55.
- The methodology provides "practical certainty to tax practitioners, appraisers, and financial planners alike."
- It "eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking."
- "It is a welcome roadmap for those in the judiciary not formally trained in the art of valuation."
- "This type of economic reality approach mimics the marketplace and places a practical, transactional overlay upon the proverbial willing buyer – willing seller analysis."

Controversy is sure to follow this decision. While it is a very big win for the taxpayer it raises the question of whether the court inadvertently changed the standard of value from Fair Market Value to Liquidation Value. While the court decision addresses the issue of the willing buyer in relationship to the imbedded tax liability, not much was said about the willingness of the seller to accept such a deep discount. That, in essence, is the substantive argument of the dissenting opinion. Perhaps a signal that the issue may not yet be resolved is the last sentence in the dissenting opinion: "I dissent from the majority's perilous decision."

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