
Appropriate Consideration of the Capital Gains Tax Liability In Market Value Conclusions of Pass Through Entities

William C. Herber, CBA and Scot A. Torkelson, CBA

Introduction

There is considerable confusion about the proper treatment of the capital gains taxes associated with pass through entities when performing business valuations. It is especially problematic when the appraisals are conducted for Gift and Estate Tax purposes. Business valuations are guided by IRS Revenue Ruling 59-60 which defines market valuation, for tax purposes, as follows:

"The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."

This definition clearly indicates that market value is the "price at which the property would *change hands* . . ." (Emphasis added) and is equivalent to what is meant by a transaction, defined as "an agreement between a buyer and a seller to exchange an asset for payment." Thus, fair market value is supposed to estimate the value of the exchange between buyer and seller in terms of the sum of money that passes across the table from buyer to seller in exchange for an asset.

A proper understanding of just what fair market value measures is critical to the proper determination of value; if what we have just described is the definition of fair market value, then it is NOT a net proceeds estimate of value to a seller. Fair market value is NOT an estimate of what the seller received after paying all expenses associated with the sale - broker's fees, listing fees, capital gains taxes, debts, etc. These are all costs incurred by the seller personally and they are not part of the exchange, these costs are the seller's alone and do not change hands from the buyer to the seller.

Nor is fair market value an estimate of value from the buyer's position apart from the exchange, which may include costs incurred in finding a business to buy, or exercising due diligence before buying the asset. Any broker's fees, legal costs, and any other expenditures of the buyer are likewise not considered a part of the transaction between buyer and seller.

The confusion around fair market value conclusions stems precisely from a wandering off from the focus on the "changing of hands" or the "exchange between a willing buyer and willing seller" by the appraiser, who erroneously includes those costs or circumstances which are related to the seller or buyer alone. Nowhere is this more true than the deduction of capital gains taxes; they are not part of the exchange, but are costs of the seller only.

Capital Gains Tax Liability for Pass Through Entities

Simple Discussion of Capital Gains Taxation for Pass Through Entities

We begin with a simple example. If a sole proprietorship (the simplest of pass through entities) owner were to sell a business for \$5,000 that had been purchased for \$4,000 (basis), then the seller must pay a capital gains tax on the \$1,000 gain. The tax is paid at the time of the sale. Assuming a personal tax rate for pass through entities at 20%, a total of \$200 would need to be paid by the seller and the net proceeds of the sale would be \$4,800.

What is the fair market value of the business? In this example the fair market value is \$5,000, or the price at which the sale transacted, was exchanged, between the buyer and seller - this amount is what the buyer paid to the seller. It is not the \$4,800 net proceeds realized by the seller after payment of capital gains tax because the payment of the capital gains tax was by the seller only; it was not part of the exchange. On the buyer's side of the transaction, if a consultant had been hired to find the business and the buyer had paid a \$200 finder's fee, that also is not part of the fair market value because the \$200 was not paid from the buyer to the seller. It was part of the buyer's own due diligence.

The transaction looks like this:

Seller Transaction \$5,000 Cap Gain (\$200) <hr style="width: 50%; margin: 0 auto;"/> Net Proceeds at \$4,800	Transaction \$5,000 Market Value	Buyer Transaction \$5,000 Consultant \$200 <hr style="width: 50%; margin: 0 auto;"/> Total Cost \$5,200
--	--	--

Regarding the example above, business appraisal principles and definitions clearly state that the focus of fair market value is on the point of exchange between the buyer and the seller. Thus, the focus is on what a buyer would pay for a given asset or business, irrespective of the seller's tax or other considerations associated with the seller alone. The question which the appraiser must ask is: in the example above, would a buyer pay any more or less for the pass through entity to account for the fact that the seller might incur personal liabilities associated with the sale, such as a capital gains tax? The answer is no. It does not figure in the exchange. There is no derived benefit or detriment to the buyer with regard to the seller's situation. It is, therefore, not a part of the transaction.

To complicate matters further, the seller of a business, real estate or capital asset can frequently avoid the capital gains tax altogether by reinvesting the sales proceeds into another, similar, capital investment. One cannot be assured that a capital gains tax will be paid by the seller even when there is a capital gain, providing us with additional evidence that capital gains taxes are not part of the transaction

Description of Pass Through Entities

The previous example reflects a Sole Proprietorship. A simple business structure of this

Capital Gains Tax Liability for Pass Through Entities

nature shares many similarities with other, more complicated, pass through business entities. Sole Proprietorships, Limited Liability Companies, Partnerships and S Corporations are all pass through entities. This means that in each of these businesses, the entity structure does not pay taxes at the corporate level. Rather, all taxes "pass through" to the individual owners at their personal tax levels. For example, company earnings are "passed through" to the owners as if they had earned the profits personally, therefore taxes are paid on their proportionate share of the business earnings at their own individual tax rates.

S Corporation Example

When owners of an S Corporation sell their interests, they pay capital gains taxes on the gain in fair market value from basis at their personal tax levels. These gains are adjusted upwards for any interim distributions they have received and decreased by any allocations of earnings on which they already paid taxes. In a pass through entity, the basis and capital gain are held personally (by each owner), until it is sold. The purpose of the pass through entity is to allow owners to avoid the double taxation, on corporate earnings, that applies to C Corporations, where the company pays taxes on profits and the owners pay taxes when the profits are distributed. At the same time, the gains/losses on capital investments are passed through to the owners personally as well and cannot be "trapped in" at the corporate or business level, as occurs with C Corporations. Because all earnings pass through to the owners, capital gain liabilities are not relevant to the transaction between a buyer and seller. Pass through earnings cannot be part of the fair market value consideration.

Thus, if a shareholder sells or redeems his or her S Corporation stock, the shareholder recognizes a capital gain or loss equal to the difference between the consideration received and his or her basis in the S Corporation stock at origination plus increases or decreases in the account equity. In this example, capital gains are not trapped in and do not pass through to the new buyer as is the case for the sale of C Corporation stock.

In the case of a partial interest sale, a 100% stock sale or even when the S Corporation is liquidated, the shareholders realize a capital gain or loss on the difference between the fair market value of the property received and their respective bases in the S Corporation stock surrendered based upon their own personal capital positions in the company. In each instance, the capital gains tax is payable by the owners/sellers of the S Corporation interest personally. The seller's basis is measured against the purchase price and there are no trapped in capital gains taxes passed to the buyer. Therefore, this cost cannot be a part of fair market value consideration. That is the essence of a pass through entity. An exception occurs when there is a sale within 10 years of the S Corporation election. The capital gain benefits of the S Corporation are voided and we have, in essence, a C Corporation sale. We assume, for purposes of this discussion, that the S Corporation follows all the rules pertaining to the election. Our S Corporation example applies to Sole Proprietorships, Partnerships, and Limited Liability Corporations as well.

C Corporation Example

While the previous example applied to pass through entities, it may not apply to entities which do not pass through, but retain their earnings. A C Corporation is a business entity whose earnings/losses do not pass through to the owners. Losses, earnings, proceeds from asset sales, and other sources of income for the business are retained by the C Corporation. The basis of the stock for the shareholders does not match the basis of the assets inside the corporation.

As a result, capital gain liabilities can be trapped inside a C Corporation entity without passing through to the shareholders. Various events, as simple as the depreciation of corporate assets, result in a declining balance of the basis, inside the business, apart from the basis of the shareholders' stock. Assume, for example, vacant land or building improvements with a basis of \$1,000,000 and a fair market value for the same asset of \$5,000,000. The C Corporation has trapped in a gain of \$4,000,000, with capital gains tax exposure of \$800,000¹* (assuming an immediate sale). The stock can sell without the real estate held inside the Corporation transacting, and this capital gains tax exposure is "trapped in".

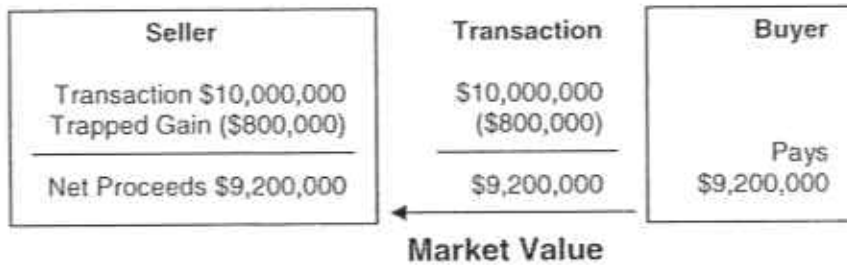
Thus, if the C Corporation were to sell stock, the sale would include the capital gains tax exposure as a part of the exchange between seller and buyer. In the case of C Corporations, the capital gains tax liability can change hands when it is "trapped in", and is, therefore, a part of the transaction from the seller to the buyer. As a part of the exchange, it may also be a factor in the fair market value considerations of the appraiser. (Discussion of additional considerations is outside the scope of this article.)

Would buyers pay less for a C Corporation knowing that they would be incurring an \$800,000 trapped in capital gains cost? Assuming a stock sale in the future, the owners of the newly acquired company would have to pay this cost. In this instance, the answer is a resounding yes. The buyers need to ascertain when that trapped in cost will be incurred and how much it will be. It is not necessarily a dollar for dollar reduction of the capital gains tax liability. Nonetheless, this cost would certainly be of concern to potential buyers. It is a part of the transaction and, by definition, a contributing factor to determining fair market value.

¹The estimated capital gains tax is for example purposes only and does not reflect the actual tax rate which may be applicable.

Capital Gains Tax Liability for Pass Through Entities

The sale looks like this:



Appropriate Deductions of Capital Gains Taxes

When is it appropriate to deduct capital gains taxes from a transaction or to include them in a fair market value conclusion? The issues of consideration of trapped in capital gains taxes in C Corporations have been discussed in several prominent Court Cases. The Second Circuit, in *Eisenberg*, set forth its rule regarding the consideration of trapped in capital gains as follows:

“Fair market value is based on a hypothetical transaction between a willing buyer and a willing seller, and in applying this willing buyer-willing seller rule, *‘the potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to maximize his advantage.... [C]ourts may not permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer....’* Our concern in this case is ... what a hypothetical buyer would take into account in computing fair market value of the stock. We believe it is common business practice and not mere speculation to conclude a *hypothetical willing buyer*, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole assets of the Corporation at issue in making a sound valuation of the property.” *Eisenberg v. C.I.R.*, 155 F.3d 50, 57 (2nd Cir. 1998) (emphasis added)

The rules are put more forcefully by the Fifth Circuit Court in *Dunn v. Commissioner* F.3d (5th Circuit 2002). The following quotes are taken from *Dunn* (emphasis is added):

“We are satisfied that the hypothetical willing buyer of the Decedent’s block of Dunn Equipment stock would demand a reduction in price for the built-in gains tax liability of the Corporation’s assets at essentially 100 cents on the dollar, regardless of his subject desires or intentions regarding use or disposition of the assets. Here, that reduction would be 34%. This is true ‘in spades’ when, for purposes of computing the asset-based value of the Corporation, we assume (as we must) that the willing buyer is purchasing the stock to get the assets, whether in or out of corporate solution. We hold as a matter of law that the built-in gains tax liability of this particular business’ assets must be considered as a dollar-for-dollar reduction when calculating the asset-based value of the Corporation, *just as, conversely, built-in gains tax liability would have no place in the calculation of the Corporation’s earnings based value.*” (In footnote 24, *Dunn* elaborates on this point by citing Pratt for the proposition that the tax consequences of ownership and/or transfer of stock usually are quite

Capital Gains Tax Liability for Pass Through Entities

different from those of ownership and/or transfer of direct investment in underlying assets.)”

“This truism is confirmed by its obverse in today’s dual, polar-opposite approaches (cash flow; assets). *The fundamental assumption in the income or cash-flow approach is that the assets are retained by the Corporation, i.e., not globally disposed of in liquidation or otherwise.* So, just as the starting point for the asset-based approach in this case is the assumption that the assets are sold, *the starting point for the earnings-based approach is that the Corporation’s assets are retained----are not sold,* (other than as trade-ins for new replacement assets in the ordinary course of business) ---- *and will be used as an integral part of its ongoing business operations.* This duly accounts for the value of assets ---- unsold ---- in the active operations of the Corporation as one inextricably intertwined element of the production of income.”

It is important to note that in both of these cases, the Court is dealing with C Corporations; companies which can have trapped in capital gains. The same arguments would not apply to pass through entities: Sole Proprietorships, Limited Liability Companies, Partnerships or S Corporations because buyers in these types of entities purchase the company and book the purchase price at its basis. There is no possibility of trapped in capital gains for pass through entities, which occur only in C Corporations. *Eisenberg* and *Dunn* stand for the proposition that, in determining whether to reduce fair market value for capital gains tax, the appraiser is to look at the sale from the buyer’s point of view when determining what a buyer would be willing to pay a seller for his/her stock. Thus, a reduction for trapped in capital gains would only be applicable to C Corporations, because only these business entities have a situation where capital gains taxes can be trapped in and passed on to the buyer. The Courts found that a seller can only seek payment and that a buyer will only pay for a future benefit or detriment that the buyer receives (or perceives him or herself to receive). That is the only value which actually transacts and the only one allowed to be considered within the fair market value conclusions.

It is also important to note that the capital gains tax discussed in all of these cases is the tax payable by the Corporation itself, not the owner or shareholder. In an S Corporation, there is no corporate tax of any kind because there is no corporate level (which is the essence of a pass through entity). When a Corporation is sold, only the tax payable by the Corporation is considered a part of the transaction. Any tax owed by the owner (seller) does not reflect in any transaction between the buyer and the seller. In all of the pass-through entities, the capital gains tax is paid only by the owner (seller). To reiterate, the capital gains tax cannot pass from the seller to the buyer and can never be a part of the transaction, which is, by definition, the basis of fair market value.

There is considerable confusion precisely at this point. Valuers continue to apply capital gains tax costs, which are payable by the seller only (within these pass through entities), and which are not a part of the corporate burden or a part of the transaction from the seller to

Capital Gains Tax Liability for Pass Through Entities

the buyer. In the absence of such a transfer, no buyer would give such costs consideration when his/her own basis is un-impacted by the capital gains taxes paid by the seller. The gains are not trapped in within the entities of Sole Proprietorships, Limited Liability Companies, Partnerships, or S Corporations. Any application of the costs of capital gains taxes is inappropriate in market valuation, just as it is inappropriate to net out such costs in the sale of any asset - whether real estate, business entity, or otherwise.

Exceptions

Are there any exceptions for S Corporation sales considering built-in capital gains? There may be a sole exception: the sale of the S Corporation occurring within 10 years of the S Corporation conversion. In such a case, for tax purposes only, the entity reverts to being considered as if it were a C Corporation. The IRS recognized that shareholders could abuse the benefits associated with the S Corporation status by choosing to elect as an S Corporation immediately before selling the business. In order to prevent this possibility, the "built-in gain" rule was created.

Whenever an existing C Corporation elects S Corporation status, the difference between the fair market value of its assets and the basis of such assets, on the date of the S Corp election, is its "built-in gain" and this gain holds true for 10 years after the S Corp election. If the assets are sold within 10 years of the election, the gain on the sale of the assets will revert to consideration as if it were still a C Corporation. Therefore, the S Corporation election must occur at least 10 years before the sale in order to avoid being treated as a C Corporation with the usual C Corporation considerations. The primary consideration here is the single and double taxation issue (the main difference between C and S Corporations), but it may also involve the issue of trapped in capital gains.

We are not considering what the appropriate fair market value principles are, in this situation, but given certain facts and circumstances they can be very unique. It is outside the scope of this discussion, but we do recognize this particular circumstance when the issue of trapped in capital gains taxes could apply to an S Corporation.

Conclusions

There is considerable confusion about the proper treatment of the capital gains taxes associated with market valuations of businesses, particularly when the appraisals are conducted for Gift and Estate Tax purposes. However, fair market value is clearly identified in Revenue Ruling 59-60 as the "price at which the property would change hands." It is, therefore, a transaction price: the monies that are exchanged from buyer to seller. It is not the net proceeds of the seller, or what the seller receives after paying all of the expenses associated with the sale. It makes no difference whether the fees are broker's fees, listing fees, capital gains taxes, debts, etc. These are all costs incurred by the seller, they are not transactions which exist between the

Capital Gains Tax Liability for Pass Through Entities

buyer and the seller, nor do they have any benefit or detriment to the new buyer.

The potential capital gains tax liability in an S Corporation, or any of the pass through entities, cannot be part of fair market value conclusions for Gift and Estate Tax Purposes (or for any valuation purpose for that matter) because the issue of basis increase (or decrease), subject to capital gains is passed through and payable by the owners only. Depreciation costs are passed through to the owners, all benefits from sale of assets, and the appreciation of assets at the time of sale pass through to the owners with capital gains taxes payable by the sellers only. Therefore, it cannot be part of the transaction.

In this article, any references to the *Eisenberg* and *Dunn* Cases apply to C Corporations only. It is only in C Corporation entities that trapped in capital gains taxes may be considered in market valuations precisely because the tax liability can pass from the buyer to the seller when it is trapped in the corporate structure and not passed through to the owners. In such situations, the buyer must consider the liability costs associated with trapped in capital gains within the transaction. In pass through entities there is no such provision for the capital gains tax liability to pass from the seller to the buyer, so it cannot be considered part of the transaction, and, by definition, cannot be considered within the fair market value calculation.

William Herber, CBA, is Vice President-Director of Business Valuation, and Scot Torkelson, CBA, is Vice President-Director of Information Systems at Shenehon Company in Minneapolis, Minnesota. Shenehon Company is a real estate and business valuation firm, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a