STOCK PURCHASE VERSUS DIRECT ASSET INVESTMENT

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Abstract: In its review of the Tax Court decision in Jameson, the Fifth Circuit noted that the stock value for estate tax purposes depends on the timberland's fair market value on the taxpayer's date of death. Any sale of the subject company shares would cause a transfer of the timberland which would trigger the built-in capital gains tax liability. The estate's valuation experts noted that the only sound economic strategy for a hypothetical willing buyer of the holding company would be an immediate liquidation of the timberland. This discussion will summarize the various issues related to the valuation of a C corporation with appreciated underlying assets. This discussion will also present a practical framework for quantifying the appropriate valuation adjustment (if any) related to the capital gains tax contingent liability related to such corporations.

Key words: decision, stock,market.

Introduction

The valuation of a C corporation is a common valuation assignment. Experienced analysts routinely value 100 percent of the stock of a C corporation for such purposes as: merger and acquisition pricing; estate and gift tax planning and compliance; shareholder buy-sell agreements; ESOP formation and ERISA compliance; transaction fairness analysis; and shareholder disputes and other litigation matters.

The valuation of a C corporation with appreciated underlying assets is also a common valuation assignment. A C corporation will have appreciated underlying assets when the market value of its owned assets exceeds the income tax basis of its owned assets. This is a common phenomenon for C corporations whether the company is (1) an operating company or (2) an investment or holding company.

When the C corporation owns appreciated assets, a question arises as to how the analyst should consider the built-in capital gains tax liability. This is the tax liability that would be paid if (and only if) the C corporation liquidated (i.e., sold) its underlying assets at their current market values. The built-in capital gains tax is determined by (1) the amount of the gain on the sale of the assets multiplied by (2) the corporation's capital gains income tax rate. Particularly with regard to the estate and gift tax arena, there is conflicting judicial precedent regarding the valuation effects (if any) of the built-in capital gains tax liability of a C corporation with appreciated assets. Some courts have allowed a valuation adjustment (i.e., a valuation discount) of 100 percent of the estimated built-in capital gains tax liability in arriving at a business value. Other courts have allowed some valuation discount—but less than 100 percent of the subject company's estimated built-in capital gains tax liability.

This discussion will summarize the various issues related to the valuation of a C corporation with appreciated underlying assets. This discussion will also present a practical framework for quantifying the appropriate valuation adjustment (if any) related to the capital gains tax contingent liability related to such corporations.

Recent judicial precedent

The *Estate of Helen Bolton Jameson,* is the most recent federal taxation precedent with regard to this valuation discount issue. In *Jameson,* the taxpayer died owning the shares of a personal holding company. The main asset of that company was timberland. The Service and the taxpayer's estate disagreed on how the built-in capital gains taxes (which would be incurred on the sale of the timber or on the sale of the land) would affect the value of decedent's interest in the corporation.

At the trial level, the Tax Court allowed a valuation discount for the capital gains tax liability that the holding company would incur but only the capital gains taxes from its ongoing timber sales. The Tax Court disallowed a valuation discount based on the immediate sale of the timberland. Instead, the Tax Court

concluded that a willing buyer of the timberland would operate it on an ongoing business. The taxpayer appealed the Tax Court decision to the U.S. Court of Appeals.

In its review of the Tax Court decision in *Jameson,* the Fifth Circuit noted that the stock value for estate tax purposes depends on the timberland's fair market value on the taxpayer's date of death. Any sale of the subject company shares would cause a transfer of the timberland which would trigger the built-in capital gains tax liability. The estate's valuation experts noted that the only sound economic strategy for a hypothetical willing buyer of the holding company would be an immediate liquidation of the timberland, thereby triggering the 34 percent capital gains tax.

According to the Appeals Court, the Tax Court should not have assumed that there was a strategic buyer for the timberland that could have continued to operate and produce timber. Instead, the Fifth Circuit stressed that a fair market value analysis depends on a hypothetical (instead of a specific) willing buyer. Therefore, according to the Fifth Circuit, the Tax Court erred in disallowing a 100 percent valuation discount for the built-in capital gains tax liability.

Lesson from judicial precedent

A review of the relevant judicial precedent indicates that, recently, federal courts are consistently allowing a valuation discount for the built-in capital gains tax contingent liability. The critical issue in most recent court cases is not: *if a* valuation discount should be allowed. The critical issue is: *how much* of a valuation discount for built-in capital gains tax should be allowed.

Acquiring the stock of a c corporation with appreciated assets

Certainly, buyers are willing to make stock acquisitions of C corporations with appreciated assets. Of course, these buyers recognize that the target C corporations come with an associated built-in capital gains tax liability. Such acquisitions are consummated if the transaction purchase price is sufficiently discounted to reflect the economic impact of the built-in capital gains tax liability.

In fact, if the transaction purchase price (i.e., the C corporation value) is appropriately discounted for the effect of the capital gains tax on the target company appreciated assets, the acquirer will realize the following economic benefits from the acquisition:

1. The acquirer (a) buys control of the target company appreciated underlying assets at a price discount and (b) earns investment returns based on the discounted purchase price; this has the same economic effect as an interest-free loan.
2. The "effective interest-free loan" is contingent—that is, it does not have to be "repaid" (the acquirer does not actually pay the corporate capital gains tax to the Internal Revenue Service) to the extent that the acquired appreciated assets decline in value (to their income tax basis) over time.

Therefore, some valuation analysts have argued (and some court decisions have held) that the value of a C corporation should be greater than the subject company's net asset value adjusted (i.e., discounted) for a full 100 percent of the built-in capital gains tax liability.

Stock Purchase versus Direct Asset Investment

The economic differences (1) between acquiring 100 percent of the stock of a C corporation and (2) making a direct investment in the underlying asset (through the use of borrowing) are:

1. The direct investment in the underlying asset requires the payment of cash interest expense during the investment holding period, a factor in favor of the acquisition of the C corporation stock.
2. The debt associated with the direct investment in the underlying asset is (a) fixed and (b) not contingent on earning any particular rate of return on the underlying asset, a factor in favor of the acquisition of the C corporation.
3. The direct investment in the underlying asset has a greater tax basis (i.e., $1,000) than the investment in the C corporation stock, a factor in favor of the direct investment in the underlying asset.

4. The acquisition of the C corporation stock means that all of the investment returns will be subject to double taxation (i.e., once at the corporate level and once at the distributee/shareholder level), a factor in favor of the direct investment in the underlying asset.

There is a potential economic disadvantage of acquiring the C corporation stock (with the built-in capital gain liability) relative to a direct investment in the underlying appreciated assets. This relative economic disadvantage depends on whether (1) the amount of the built-in capital gains tax liability of the C corporation is less than (2) the avoided cost of debt service from the direct investment in the underlying asset.

Valuation adjustment illustrative example

In the following discussion, we will present the comparative after-tax results of these two investment alternatives: (1) the acquisition of C corporation stock versus (2) underlying appreciated assets. We will analyze these two investment alternatives over a 10-year investment holding period.

It is noteworthy that our illustrative example assumptions present the most favorable case for measuring the economic advantage of the acquisition of the C corporation stock (relative to the direct purchase of the underlying asset). For example, all of the analyses assume that (1) the inside tax basis of the C corporation assets is zero and (2) the avoided cost of borrowing (i.e., the debt interest rate) is equal to the expected rate of return on the asset investment.

Adjusted base case scenario

Considering the put options, the asset purchase debt is arguably risk-free to the lender. This assumption supports an 8 percent interest rate spread. In the analysis presented in Table III, the direct asset investment alternative clearly generates a greater after-tax benefit than does the purchase of the C corporation (Target Company) stock.

In the direct asset purchase alternative, Buyer can cover this contingency by purchasing a put option. The put option will have a strike price equal to the market value of the security in an amount equal to the value of the security times the corporate tax rate. The intrinsic value of the put option would exactly offset the amount by which (1) the return on the investment in the C corporation exceeds (2) the return of the direct investment under any combination of tax assumptions and basis assumptions.

Where Target Company has any positive tax basis in the purchased assets, we assume that the sale at a loss will generate an income tax benefit equal to (1) the income tax rate times (2) the amount of the loss. To the extent that there is no "inside" income tax benefit available from the loss, the put strategy should be correspondingly adjusted.

Put option strategy

Whether or not the direct asset purchase alternative is more attractive than the purchase of Target Company stock depends on (1) the price of the put relative to (2) the financial advantage of the direct asset purchase.

We should, therefore, adjust the amount of the year 10 value to a present value. The discount rate for this calculation is adjusted to reflect the fact that the excess of the year 10 benefit of the direct asset investment alternative is after individual income taxes.

The rate of return assumption is, therefore, adjusted to reflect the fact that the year 10 benefit is after tax. This adjustment is based on individual income tax rates. The present value of the after-tax amount of excess return is the maximum amount the direct asset investor would pay for the put option.

The maximum price of the put option using "real world" assumptions amounts to approximately 53 percent of the value of the underlying asset. Based on "real world" assumptions, Buyer would pay no more than 53 percent of the asset value of the direct asset investment alternative for the put option.

Subchapter Selection

Accordingly, let's expand the analytical model to allow for the avoidance of the capital gains tax entirely. This assumption regarding the deferral/avoidance of capital gains tax makes the acquisition of the C corporation stock more attractive than the direct purchase of the underlying assets.

However, the price that Buyer will pay for the C corporation stock is affected by the illiquidity of the S election. That price reflects the fact that the asset cannot be sold—and therefore lacks marketability—for the statutory 10-year holding period. A sale of the appreciated asset within the 10-year holding will generate a lower rate of return than a direct purchase of the underlying asset.

The lack of marketability impact is measured by setting (1) the after-tax terminal value of the C corporation alternative equal to (2) the after-tax (post-debt) terminal value of the direct asset purchase alternative. By solving for the beginning dollar amount of the stock required to be inside the C corporation, we can estimate the amount of stock necessary to provide an equivalent rate of return to the direct asset purchase alternative.

It would be a lesser amount because both (1) the cost of borrowing and (2) the built-in capital gains tax are avoided. The amount, however, has a bearing on whether or not Buyer is willing to "lock up" the asset ownership position—that is, to forgo marketability, for 10 years.

Simplifying assumptions

For purposes of the analysis , we made the following simplifying assumptions:

- Transaction costs are ignored. 88 Dividends are assumed to be zero.
- The price of a 10-year put option is estimated using market volatility, current risk-free rates of return, an assumption of zero dividends, and a 10-year duration in the Black-Scholes option pricing model.

The Black-Scholes option pricing model may not be the best analytical procedure for estimating the price of a long-term option. Moreover, the price of a series of put options covering the interest component of the direct asset investment alternative is ig no red.

If we assume the cost of these options was the same as the put on the principal (which is probably overstating the case), then the basic conclusion remains the same.

- The price of put options is not considered in the estimate of the discount for lack of marketability. This discount is used in measuring the rate of return on the direct asset investment in order to set it equal to the C corporation asset. This assumption does not change the basic conclusion.
- Income taxes are estimated as follows:

1. The income tax benefit of the interest deduction is simply considered an addition to tax basis in year 10, and the individual capital gains tax rate is used. To the extent that a current interest expense deduction is available at ordinary income tax rates, it is an economic benefit to the direct asset investment alternative.
2. The income tax basis in the put option is ignored in all calculations
3. The proceeds from the exercise of the put option is assumed to offset the loss on the underlying asset. The income tax benefit of the loss is calculated at the assumed individual income tax rate.
4. Losses at the individual taxpayer level are assumed to generate an economic benefit equal to the income tax rate times the amount of the loss.
5. Losses inside the Target Company C corporation are assumed to generate income tax benefits equal to (a) the corporate income tax rate times (b) the amount of the loss.
6. State and local income taxes are ignored.

Summary and Conclusion

Each S corporation valuation depends on its unique set of facts and circumstances. However, there appears to be no financial advantage to (1) the stock acquisition of a C corporation with built-in capital gains relative to (2) the direct purchase of the underlying assets and a put option. Accordingly, no willing buyer would pay a price premium for the acquisition of the C corporation stock over the tax adjusted net asset value of the target. company. No willing buyer would pay a price premium over the target company tax-adjusted net asset value, and no willing seller would accept less than the target company tax-adjusted net asset value.

The principal reason for this outcome is the fact that 100 percent of the gains inside the target corporation are subject to double taxation. This double taxation offsets the apparent financial benefits described in the introduction. No rational tax adviser will advise a client to structure his or her transactions in a way that will subject investment returns to double taxation if it can be avoided.

The apparent economic advantage of (1) buying the C corporation stock and (2) electing S corporation status is more than offset by the fact that the underlying assets become non-marketable for a 10-year holding period.

Any asset holding period of less than 10 years will cause the direct asset purchase alternative to generate a greater after-tax rate of return than the acquisition of C corporation stock alternative.

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