



FCG Estate & Gift Valuation E-Flash

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CITATION:

Litchfield v. Commissioner, T.C. Memo. 2009-21, January 29, 2009 The Tax Court calculated the discount for built-in capital gains taxes in a recently converted “C” to “S” corporation, along with discounts for lack of control, and lack of marketability.

COMMENTS:

Regarding the capital gains tax issue, the court’s ruling in *Litchfield* appears to be consistent with its ruling in *Estate of Jelke v. Commissioner* T.C. Memo 2005-131, but contrary to the 11th Circuit’s reversal of *Jelke* in *Estate of Jelke III v. Commissioner* 507 F.3d 1317 (11th Cir. 2007), and the Fifth Circuit’s ruling in *Estate of Dunn v. Comm’r*, 301 F.3d 339 (5th Cir. 2002). As a result, advisors and analysts should carefully review and understand the issues associated with C corporations built-in capital gains taxes.

The estate’s expert was criticized for relying on out of date restricted stock studies. Analysts should consider including an explanation stating that the regulatory rights afforded shareholders in the more recent studies differ from those in the earlier studies. When one considers the differences in those rights, the newer studies do not differ significantly from the earlier studies. Furthermore, the rights associated with closely-held business interests often are more similar to the stocks included in the older studies.

THE FACTS:

Marjorie deGreeff Litchfield died in 2001, owning minority 43.1- and 22.96-percent interests in Litchfield Realty Co. (LRC) and Litchfield Securities Co. (LSC), respectively.

LRC converted to an S corporation on January 1, 2000. It owned appreciated assets, including farmland, marketable securities, and a closely-held subsidiary. LRC occasionally sold farmland to raise capital.

LSC was a C corporation that owned blue-chip marketable securities and other equity investments. It focused on maximizing cash dividends and dividends increased consistently over time.

Built-in capital gains represented 86.7- and 73.8-percent of LRC and LSC’s net asset values, respectively.

DISCOUNT FOR BUILT-IN CAPITAL GAINS TAXES:

The Estate

Based on the estate expert's analysis, average holding periods for LRC and LSC's assets were calculated and present values of the estimated future capital gains tax liabilities were deducted from net asset value.

The IRS

The IRS expert calculated different holding periods, multiplied the tax rate at the end of each period by the capital gains, discounted the conclusions back to present values, and recognized the liabilities. For LRC, however, no capital gains taxes were recognized beyond 2009 because of its recent S election.

Court Analysis

The IRS expert did not account for appreciation during the holding period. Additionally, the estate's assumptions regarding asset turnover estimates were based on more accurate data, including management interviews. The court accepted the estate's built-in capital gains tax discounts.

DISCOUNT FOR LACK OF CONTROL:

The Estate

The estate's expert compared both companies' securities business segments to closed-end funds. Additionally, LRC's farmland and other assets were compared to real estate investment trusts (REITs) and real estate limited partnerships (RELPs).

The IRS

The IRS expert also selected closed-end fund data for LRC's and LSC's marketable securities' business segments. LRC's farmland segment analysis was based on a variety of published data, including *Mergerstat Review*.

Court Analysis

The court acknowledged that both experts averaged their discounts for the farmland and securities business segments. However, the estate's expert used a weighted average to account for the proportionately greater value in LRC's farmland segment, while the IRS expert used a simple average.

Regarding the LSC stock interest, the IRS expert used the same DLOC for both businesses' security segments even though the estate's ownership interest in LSC was much smaller than its stock interest in LRC. In contrast, the estate's expert relied on a larger DLOC for LSC.

The court concluded the estate's DLOCs were appropriate.

DISCOUNTS FOR LACK OF MARKETABILITY:

The Estate

To calculate an appropriate discount for lack of marketability (DLOM), the estate's expert compared the stock of LRC and LSC to restricted stock transactions using five criteria.

The IRS Using a nine-point analysis, the IRS expert also compared both companies' ownership interests to restricted stock sales (including three studies of restricted stock sales from the late 1990s that the estate's expert did not review). Additionally, the expert reviewed private placement data.

Court Analysis

The court concluded the estate's selection of DLOMs were high, in part because the estate's expert relied on allegedly outdated data. The court also recognized the estate's expert concluded that a much smaller DLOM was appropriate in a March 2000 gift tax appraisal for the same LSC minority stock interest. As a result, the court chose DLOMs of 25% and 20% for LRC and LSC, respectively.

CONCLUSION:

A summary of the parties' conclusions are shown in the following table.

LRC - 43.1% interest	Estate	IRS	Court
Net asset value	\$33,174,196	\$33,174,196	\$33,174,196
NAV (43.1% interest)	\$14,298,078	\$14,298,078	\$14,298,078
Less discounts for:			
Built-in capital gains taxes	17.4%	2.0%	17.4%
Lack of control	14.8%	10.0%	14.8%
Lack of marketability	36.0%	18.0%	25.0%
Opinion of FMV	\$6,475,000	\$10,069,886	\$7,546,725

LSC – 22.96% interest

Net asset value	\$52,845,562	\$52,845,562	\$52,845,562
NAV (22.96% interest)	\$12,133,341	\$12,133,341	\$12,133,341
Less discounts for:			
Built-in capital gains taxes	23.6%	8.0%	23.6%
Lack of control	11.9%	5.0%	11.9%
Lack of marketability	29.7%	10.0%	20.0%
Opinion of FMV	\$5,748,000	\$9,565,535	\$6,530,790

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