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SUGGESTIONS FOR PERSERVING WEALTH

July 23, 2010

THE ESTATE OF LITCHFIELD v. COMMISSIONER: THE DISCOUNT DEBATE CONTINUES

A recent tax court decision addressed issues involving the percentage discounts that should be used for built-in capital gains taxes, for lack of control ("LOC"), and for lack of marketability ("LOM") relating to an estate's minority interests in two closely held family corporations.

The decedent in the case, Marjorie deGreeff Litchfield, died on April 17, 2001. Decedent's husband, Edward S. Litchfield, died in 1984. On the date of his death, he owned minority stock interests in two closely held family-owned corporations named Litchfield Realty Co. ("LRC") and Litchfield Securities Co. ("LSC"). LRC invested in and managed farmland, marketable securities and other property with substantial built-in (i.e., unrealized) capital gains. Both interests benefitted Ms. Litchfield through a QTIP trust established under the will of Mr. Litchfield.

LRC was originally formed as a "C" corporation, but converted to an "S" corporation on January 1, 2000. "S" corporations pay no corporate-level taxes. However, under current tax law, pre-conversion assets sold before the date which is ten years after the effective date of the Subchapter "S" election, remain subject to corporate-level tax on built-in gains existing on the date of the Subchapter "S" election. LRC was a "C" corporation that invested in marketable securities and also had substantial built-in capital gains.

Valuation experts on both sides used the net asset value method to determine the fair market value of Ms. Litchfield's estate's interest in LRC and LSC. They also agreed that valuation discounts were appropriate to reflect built-in capital gains tax liability, for LOC, and LOM. They differed, however, on the size of those discounts. The chart below shows the discounts proposed by the parties and those accepted by the court. The court accepted the estate's expert's discounts for built-in capital gains largely because the estate relied on more current, company-specific information, including anticipated sales of corporate assets. The estate's expert also relied on historical data, recent data and conversions, and conversations with management. The IRS expert relied solely on historical asset sales.

For each company, the estate's expert: (a) projected holding periods and sale dates for appreciated assets, estimated appreciation for those assets, and the resulting capital gains taxes; (b) discounted the tax liability to present value; and (c) subtracted that figure from the company's net asset value. The court also preferred the estate's expert's discounts for lack of control.

With regard to LRC, the two experts used methods that were similar in many respects, but the estate's expert calculated separate discounts for real estate and securities and used a weighted average for the two, while the IRS expert used a straight average. With regard to LSC, the IRS expert used the same 5% discount for its marketable securities that he applied to the marketable securities portion of LRC's holdings, even though the estate's interest in LSC was much smaller. The court found that the estate's expert correctly applied a higher lack of control discount to LRC's securities holdings.

LITCHFIELD REALTY CO.

In U.S. Dollars	*Estate's Expert*	*IRS Expert*	*Court Decision*
1. Net Asset Value	*$33,174,196*	*$33,174,196*	*$33,174,196*
2. Pro-Rata Value of Estate's Interest (43.1%)	*14,298,078*	*14,298,078*	*14,298,078*
Less Discounts for:			
3. Built-in Capital Gains Taxes	*17.4%*	*2%*	*17.4%*
4. Lack of Control	*14.8%*	*10%*	*14.8%*
5. Lack of Marketability	*36.0%*	*18%*	*25.0%*
6. Total Effective Valuation Discount	***55.0%***	***28%***	***47.2%***
7. Fair Market Value of Estate's Interest	***$6,475,000***	***$10,069,856***	***$7,546,725***

Source: T.C. Memo, 2009-21 (Docket No. 15882-05), filed 1/29/09

LITCHFIELD SECURITIES CO.

In U.S. Dollars	*Estate's Expert*	*IRS Expert*	*Court Decision*
1. Net Asset Value	*$52,845,562*	*$52,845,562*	*$52,845,562*
2. Pro-Rata Value of Estate's Interest (22.96%)	*12,133,341*	*12,133,341*	*12,133,341*
Less Discounts for:			
3. Built-in Capital Gains Taxes	*23.6%*	*8%*	*23.6%*
4. Lack of Control	*11.9%*	*5%*	*11.9%*
5. Lack of Marketability	*29.7%*	*10%*	*20.0%*
6. Total Effective Valuation Discount	***52.7%***	***21%***	***46.2%***
7. Fair Market Value of Estate's Interest	***$5,748,000***	***$9,565,535***	***$6,530,790***

Source: T.C. Memo, 2009-21 (Docket No. 15882-05), filed 1/29/09

As discussed above, the Litchfield case highlights the need not only for retaining qualified valuation experts, but also for using the most precise methods and the most current data available for each case. This approach proved beneficial to the estate; overall, the "gross discount" from NAV after all three discounts were applied was 47.2% for LRC and 46.2% for LSC!

Glenn Booker is a Certified Business Appraiser by the institute of Business Appraisers.
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GMB/32-195-2010-01