John G. Mack, ASA, CBA
Mack Business Appraisals, LLC
26956 N. 90th Lane
Peoria, Arizona 85383
(888) 789-2401 (toll free) (623) 340-6770 (direct) (623) 476-5405 (fax)
john@mackbusinessappraisals.com
www.mackbusinessappraisals.com

Estate of Marjorie deGreeff Litchfield, Deceased, George B. Snell and Peter deGreeff Jacobi, Coexecutors vs. Commissioner of Internal Revenue Service, Respondent, T.C. Memo 2009-21, January 29, 2009.

The Facts:

Marjorie deGreeff Litchfield ("Ms. Litchfield") died on April 17, 2001. Her husband had previously died back in 1984. The estate for Ms. Litchfield elected the alternate valuation date of October 17, 2001 ("the valuation date"). As of the valuation date, Ms. Litchfield owned, among other assets, minority equity interests in two closely held family-owned corporations; Litchfield Realty Co. (LRC) and Litchfield Securities Co. (LSC).

LRC had been incorporated in 1921 in Delaware as a C-Corporation to manage farmland and other assets the family owned in the state of Iowa. LRC elected to convert from a C-Corp to an S-Corp effective January 1, 2000. As of the valuation date, Ms. Litchfield controlled, directly and indirectly, approximately 43.1% (or 215,556 shares of the 500,000 outstanding shares) of LRC stock. LRC's assets as of the valuation date consisted largely of farmland and marketable securities, and a subsidiary corporation that owned and operated a public grain elevator, sold crop insurance to farmers, and provided pesticide and fertilizer application services. LRC's total asset value was $33,174,196 which included $28,762,306 of built-in gains (or 86.7% of LRC's total net asset value).

LSC was incorporated in 1924 in Delaware as a C-Corporation to invest in marketable securities. As of the estate's valuation date, LSC had approximately 50 shareholders who were all members of the Litchfield family and Ms. Litchfield controlled, directly and indirectly, approximately 22.96% (or 38,808 shares of the 168,990 outstanding shares) of LSC stock. LSC's assets as of the valuation date included blue-chip marketable securities as well as partnership and other equity investments. LSC's total asset value was $52,824,413 which included $38,984,799 in built-in gains (or 73.8% of LSC's total net asset value).

The capital gains tax rate applicable to LRC and LSC, as of the valuation date, was between 35.5% and 39.1%. Both LRC and LSC's stock transfer policies discourages stock redemptions and sales to outsiders. In addition, LRC maintained a right of first refusal to buy any LRC stock a shareholder may wish to sell.

The estate timely filed an estate return utilizing the alternate valuation date. The estate's valuation expert prepared a report in which he discounted the estate's 43.1% equity interest in LRC by 17.4% for built-in capital gains, taxes, by 14.8% for lack of control and by 36.0% for lack of marketability, for a fair market value of $6,475,000. The same valuation expert prepared a report in which the estate's 22.96% equity interest in LSC was discounted by 23.56% for built-in capital gains taxes, 11.9% for lack of control and by 29.7% for lack of marketability, for a fair market value of $5,748,000. The estate tax return was filed on June 27, 2002, showing a total taxable estate of $56,057,800, a total estate tax liability of $22,396,609, and a $3,391 overpayment as a result of $22.4 million in estimated Federal estate taxes the estate had paid.

In March of 2003, the IRS began the audit proceedings by mailing a request for additional financial documents to the estate and scheduling a hearing for April 17, 2003. The estate's representatives were present and cooperative for the hearing. At the end of the meeting, due to the volume of documents provided, the IRS representative asked that all documents, along with additional documents not provided, be mailed directly to his office for review. He did not make copies of any documents he had seen at this initial meeting. The estate's representatives compiled and supplied, along with transmittal letters providing listings of the documents sent, all requested documents. Upon the completion of the audit, the IRS representative issued a notice of deficiency to the estate on June 14, 2005, of $6,223,176 of estate tax. The IRS valued LRC at over $3.8 million more than reported by the estate and LRS at slightly over $3.0 million more than reported by the estate.

<u>The Arguments:</u>

First, on April 5, 2007, just days before the start of trial, the IRS representative informed the estate's representatives for the first time that not all documents requested at their initial meeting in April of 2003 had been submitted and thus, argued that the burden of proof on factual issues should be on the taxpayer. However, the Court's main issue for decision involved the percentage discounts that should have been used for built-in capital gains taxes, lack of control and lack of marketability relating to the estate's minority interests in two closely held family corporations. The Court emphasized that resolution of valuation issues typically involves approximation by the parties, the experts and the courts and that a Court's valuation need not be tied to specific testimony or evidence if it is within the range of the supported evidence.

Both parties' experts utilized the net asset valuation method to determine the fair market values of the estate's minority equity interests in LRC and LSC. Both experts also applied a discount to the net asset values to reflect the built-in capital gains taxes associated with LRC's and LSC's appreciated assets. Finally, both experts also applied discounts for lack of control and lack of marketability when determining the fair market value of the equity interests being valued. Both experts also agreed that, as of the valuation date, LRC and LSC has net asset values of $33,174,196 and $52,824,413, respectively and before discounts the net asset value of the estates 43.1% and 22.96% minority interests in LRC and LSC were $14,298,078 and $12,128,485, respectively.

As mentioned earlier, the estate's expert had prepared a report in which discounts of 17.4% for built-in capital gains, taxes, by 14.8% for lack of control and by 36.0% for lack of marketability were given to the estate's 43.1% stock interest in LRC. In addition, discounts of 23.56% for built-in capital gains taxes, 11.9% for lack of control and 29.7% for lack of marketability were given to the 22.96% stock interest owned by the estate in LSC.

The IRS expert prepared a report showing much lower discounts of 2.0% for built-in capital gains tax, 10.0% for lack of control and 18.0% for lack of marketability on LRC, and 8.0% for built-in capital gains taxes, 5.0% for lack of control, and 10.0% for lack of marketability of LSC.

The Findings:

First, the Court found that the arguments raised by the IRS on the burden of proof were without merit and that the estate qualified for the shift in the burden of proof under Section 7491(a)(1) on the factual issues as to the appropriate discounts for built-in capital gains tax, for lack of control and for lack of marketability.

Second, the Court reviewed the methodology used by both experts to determine the discounts. Regarding the built-in gains tax discount, the Court felt that the assumptions utilized by the estate's expert were based on more accurate data as the estate's expert considered both historical turnover as well as discussions with LRC and LSC management regarding future asset turnover. The IRS expert also forgot to account for any future appreciation during the holding period that will likely occur. Thus, the Court approved the built-in capital gains discount as determined by the estate's expert.

Regarding the lack of control discount, the Court also approved the lack of control discount as determined by the estate's expert as the estate's expert used a weighted average approach of assets by category (real property versus marketable securities) as opposed to the IRS expert using a straight average. Thus, the Court sided with the estate's expert as the estate's expert accounted for the asset mix in LRC and LSC.

Regarding the lack of marketability discount for LRC and LSC, the Court determined that the 36% and 29.7% lack of marketability discounts, when combined with the 14.8% and 11.9% lack of control discounts allowed, were "high." The Court felt that (1) the estate's expert used some outdated studies related to restricted stock discounts and (2) the estate's expert had opined that, in another valuation report for Federal gift tax purposes in March of 2000, the appropriate marketability discount was only 21.4% (instead of 29.7%) for the estate's same 22.96% equity interest. Thus, the Court concluded that the appropriate lack of marketability discount was 25% for the estate's minority equity interest in LRC and 20% for the estate's minority equity interest in LSC.

Parting Thoughts:

Overall, quite an impressive victory for the estate. For both the capital gains discount and the lack of control discount, I thought the estate's expert did an excellent job of analyzing and fully supporting the discount conclusions and was properly acknowledged by the Courts through full acceptance of the estate's expert's methodology and discounts. Overall, the "gross discount" from NAV after all three discounts were applied in this situation was 47.8% for LRC and 46.2% for LSC. Not too bad, huh?