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# Estate Wins the Discount War

In *Estate of Litchfield v. Commissioner*, the Tax Court generally accepted the estate's proposed valuation discounts because the estate's expert's methods were more precise and relied on more recent, company-specific data.

### Discounts debated

The case involved the valuation of minority interests in two family-owned corporations: Litchfield Realty Co. (LRC) and Litchfield Securities Co. (LSC). LRC invested in and managed Iowa farmland, marketable securities and other property with substantial built-in (that is, unrealized) capital gains.

LRC was originally formed as a C corporation but converted to an S corporation on Jan. 1, 2000. Generally, S corps pay no corporate-level taxes. But under IRC Section 1374, preconversion assets sold before Jan. 1, 2010, remain subject to corporate-level tax on built-in gains existing on the conversion date. LSC was a C corp that invested in marketable securities and also had substantial built-in capital gains.

Valuation experts on both sides used the net asset value (NAV) method to determine the fair market value of the estate's interests in LRC and LSC. They also agreed that valuation discounts were appropriate to reflect built-in capital gains tax liability, lack of control and lack of marketability. They differed, however, on the size of those discounts. *(The chart 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 expert relied on more current, company-specific information, including anticipated sales of corporate assets. The expert relied on historical data, recent data and conversations with management. The IRS expert relied solely on historical asset sales.

For each company, the estate's expert projected holding periods and sale dates for appreciated assets, estimated appreciation for those assets and the resulting capital gains taxes, discounted the tax liability to present value and subtracted that figure from the company's NAV.

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 of the two, while the IRS's expert used a straight average. With regard to LSC, the IRS's 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 control discount to LSC's securities holdings.

Although the court agreed with the estate's expert's methods for calculating marketability discounts, it adjusted them downward because it felt they were too high compared to benchmark studies, and they relied on outdated data relating to restricted stock discounts. In addition, the discounts were higher than those the same expert had used a year earlier in valuing the interest in LSC for federal gift tax purposes.

### What can be learned?

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 the particular situation.

### Proposed Discounts in *Litchfield* Case

| Discount | Estate | IRS | Court |
|---|---|---|---|
| **LRC** | | | |
| Built-in gain | 17.4% | 2.0% | 17.4% |
| Lack of control | 14.8% | 10.0% | 14.8% |
| Lack of marketability | 36.0% | 18.0% | 25.0% |
| **LSC** | | | |
| Built-in gain | 23.6% | 8.0% | 23.6% |
| Lack of control | 11.9% | 5.0% | 11.9% |
| Lack of marketability | 29.7% | 10.0% | 20.0% |

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