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Tax Court Decision on Discounts and Embedded Taxes Hinges on Experts

***Estate of Litchfield v. Comm'r*, 2009 WL 211421 (U.S. Tax Court)(Jan. 29, 2009)**

The $26.4 million Litchfield estate consisted primarily of minority stock interests in two family owned companies, Litchfield Realty Co. (LRC) and Litchfield Securities Co. (LSC). The Internal Revenue Service (IRS) and the estate agreed on the net asset values (NAV) of the estate's interests. However, they aggressively disputed the discounts related to built-in capital gains taxes, lack of control, and lack of marketability.

Built-in capital gains tax would consume majority of NAV. When Marjorie Litchfield died in 2001, her estate owned a 43.1% interest in LRC, which held primarily Iowa farmland and marketable securities. LRC earned a marginal profit, but the company was not performing up to management expectations or the performance of Midwestern farmland generally. Historically, the company had sold portions of its farm holdings to raise cash.

To increase profitability and shareholder returns, LRC converted from a C corporation to an S corporation in January 2000. However, for the 10 years following conversion, if the company sold any of its former C Corp assets then it would incur corporate-level tax on the sale (per IRC Sec. 1374). As of the valuation date, LRC's total NAV of $33.2 million included $28.8 million in built-in capital gains tax liability—or 86.7% of NAV. Just over $19.8 million of the built-in capital gains taxes related to its farm holdings and $9.0 million to its marketable securities.

To prepare the estate's tax return in connection with its 43.1% interest in LRC, its expert appraised its share at a fair market value of $6.5 million—after application of discounts for built-in capital gains taxes (17.4%), lack of control (14.8%), and lack of marketability (36%). On audit, the IRS valued the same interest at just over $10 million, applying only a 2% discount for embedded taxes, 10% for lack of control, and 18% for lack of marketability. It assessed a deficiency of approximately $3.8 million.

The estate's 23% interest in LSC, a C corporation that held primarily "blue chip" marketable securities and partnership investments, had a NAV of $52.824 million. Like LRC, none of the LSC stock had ever been publicly traded and it was subject to substantial restrictions. Its investment strategy focused on continuing to maximize cash dividends to shareholders. In fact, in the late 1990s, the directors became concerned that elderly shareholders in both LRC and LSC would not have adequate reserves to pay for estate taxes and other obligations, and after the death of Mrs. Litchfield, they sold some assets in both entities to raise stock redemptions.

As of the valuation date, LSC's NAV included nearly $39 million in built-in capital gains, or 73.8% of its total NAV. *Note:* The capital gains tax applicable to both companies ranged from 35.5% to 39.1%. The estate's expert discounted its 23% LSC interest by capital gains tax as well as lack of marketability and control, but on audit, the IRS determined a deficiency of over $3.0 million.

The Tax Court considered each of the experts' discounts in turn.

1. Built-in capital gains taxes. The estate's expert reviewed historic asset sales for both entities along with board meetings and management plans for future sales. He estimated a 5-year holding period for LRC and 8 years for LSC to reach discounts of 17.4% and 23.6%, respectively. By contrast, the IRS expert used turnover rates based solely on historical asset sales, projecting a holding period of 53 years for LRC and 29 years for LSC to derive his discounts of 2% and 8%, respectively.

Given the "highly appreciating non-operating investment assets" that both companies held, the Tax Court considered it likely that a hypothetical buyer and seller would negotiate "substantial" discounts for the embedded tax liability. Further, the estate's expert based his asset turnover on more accurate data, in particular his conversations with management and review of

current sales. By contrast, the IRS expert looked only at historic data and did not account for appreciation. The court adopted the estate's discounts for built-in capital gains tax, without adjustment.

2. Lack of control. To determine the discount for lack of control (DLOC) for LRC securities and farm holdings, the estate's expert reviewed data from closed-end funds as well as real estate investment trusts) and limited partnerships. He then reviewed entity-specific factors, weighted for the combined asset classes, to calculate a 14.8% DLOC. He performed a similar exercise using closed-end funds to calculate an 11.9% DLOC for the estates interest in LSC.

The IRS expert claimed that because LRC's assets were performing well, a buyer would not expect a large DLOC. Without breaking down his analysis by asset class, he reviewed closed end funds, trimming the average, to calculate a 5% DLOC for LSC's marketable securities. For its farm holdings, the IRS expert reviewed a variety of public sales data to posit a range of 17% to 20% DLOC. Because discounts for public takeovers are generally higher than those for "normal" sales activity, he said, LRC's farming assets merited a lower DLOC of 15%. Even though the farmland comprised the bulk of the firm's NAV, he averaged the two findings (5% and 15%) to conclude an overall DLOC for the estate's interest in LRC of 10%.

For LSC, the IRS expert used the "trimmed mean" from the closed-end funds. Because the estate's 22.96% interest was the single largest block of stock, its returns were good, and a purchaser would not want to change operations, a hypothetical buyer "would place no value on control," he believed, and a "nominal" DLOC of 5% was appropriate for LSC.

The court noted that both experts calculated similar DLOCs for LRC's farming assets (15.7% vs. 15%); and both used lower-than-average discounts for its securities. But only the taxpayer's expert used a weighted (instead of a straight) average to account for LRC's more significant holdings of farm property, and the court adopted his 14.8% DLOC. Similarly, the IRS expert failed to account for the taxpayer's smaller holdings in LSC, and the court adopted the 11.9% DLOC by the estate's expert.

3. Marketability discount. The estate's expert used data from restricted stock studies as well as weighted values for entity-specific factors to calculate a discount for lack of marketability (DLOM) for LRC of 36%. He used the same restricted stock studies for the LSC interest, and after accounting for entity-specific factors and different asset classes, he applied a 29.7% DLOM.

The IRS expert looked at restricted stock studies, including three from the 1990s that the estate's expert did not consider, and private placement studies. He then adjusted for entity-specific factors, such as LRC's dividend-paying policy, the estate's sizeable interest, and stock transfer restrictions, to apply an 18% DLOM. He reviewed the same studies with reference to LSC, and because its assets were more readily ascertainable and saleable, its earning history was consistent and its management competent, he assigned it a lower than average discount of 10%.

This time, the court believed the estate's expert's DLOMs were too high, particularly when combined with his discounts for lack of control. In addition, some of his restricted stock data was aged, and, more notably, the estate's expert had determined "significantly lower" discounts for the same entities in connection with an earlier gift tax return. As a result, and without further discussion, the court concluded DLOM for the estate's respective interests in LRC and LSC of 25% and 20%. Overall, the court found that the fair market value of the estate's 43.1% interest in LRC was $7.546 million, and its 22.96% interest in LSC was worth $6.530 million.

Kentucky Adopts Majority Rule in Distinguishing Goodwill in Divorce

***Gaskill v. Robbins*, 2009 WL 425619 (Ky.)(Feb. 19, 2009)**

The wife in this case was a well-established oral surgeon. To value her practice, her CPA collected data from business records, spoke with staff during a site visit, and prepared a detailed financial and accounting report. After explaining why certain valuation approaches did not apply to a sole professional practice (no prior sales of this or similar business, and no plans to liquidate), he valued it using an asset-based approach at $221,610. He also assigned a zero value to goodwill, because the wife's role amounted to a "non-marketable controlling interest." To illustrate, he asked, "Why would a purchaser pay more than fair market value of the tangibles if [the doctor] can take her patients, go down the hall, and set up a practice?"

The husband's expert did not conduct a site visit. Instead, he took the financial data from the wife's expert and applied four different valuation methodologies: excess earnings, capitalized earnings, market approach, and adjusted balance sheet. Finding all

reliable but none determinative, he averaged the four values to conclude the practice was worth just under $670,000, which also assumed a non-compete agreement and goodwill.

The trial court adopted the $670,000 valuation, in large part because it interpreted prior state precedent as requiring it to assign some value to goodwill. The wife appealed—and the Court of Appeals reversed. But given the question of first impression, it sought interim review by the state Supreme Court for whether the goodwill of a closely held or sole proprietorship can have both personal and enterprise values when determining its worth in a divorce case.

Important questions to ask in every valuation. "The valuation of a business is complicated, often speculative or assumptive, and at best subjective," the Kentucky Supreme Court observed:

> This is particularly true…[when] the business is a professional practice with only one practitioner, clients or patients come to the business to receive that particular person's direct services, the business is not actually being sold, and the success of the business depends upon the personal skill, work ethic, reputation, and habits of the practitioner.

To help determine the fair market value of any business in divorce, a trial court should ask:

1. What is the value of the hard assets? (real estate, equipment, client lists, cash accounts)
2. What could the business earn over a reasonable time, including transferable goodwill?
3. What are the values of accounts receivable and remaining staff (or cost to replace)?

Of these, valuing the goodwill of a professional practice has been "a source of contention for many years." Prior state precedent generally accepted a firm's goodwill was a factor for the trial court to consider—but the cases had never considered whether goodwill could be allocated between the practice and the professional.

> Clearly, the practice is, in general, marital property, and therefore subject to division, but how are we to divide a person's reputation, skill, and relationships? To what extent can a buyer of a business assume that his performance will equal that of the present owner? To what extent can he take on the seller's reputation in the community?

To some extent, the court observed, a firm may be able to establish value beyond fixtures and accounts receivables. Nevertheless, in most professional practices, goodwill—like the practitioner's advanced degree—will not have any "objective transferable value on the open market." These two concepts have led courts in several jurisdictions to recognize a distinction between personal and enterprise goodwill. In particular, the court discussed *May v. May* (W.Va. 2003) and *Yoon v. Yoon* (Ind. 1999) for their summary of the now-majority rule that while personal goodwill is non-marketable and non-divisible, enterprise goodwill belongs to the business and is allocable in divorce.

The court found the *May* and *Yoon* cases "compelling." The distinction between enterprise and personal goodwill "has a rational basis that accepts the reality of specific business situations." In cases such as this one, there was little doubt that the skill, personality, work ethic, reputation, and relationships of the doctor were "hers alone," the court said, and could not be sold to a subsequent practitioner. "To consider this highly personal value as marital would effectively attach her future earnings, to which [the husband] has no claim." Moreover, if he or someone similarly situated were awarded maintenance in addition to a portion of the practice's value, then this would amount to "'double dipping,' and cause a dual inequity to [the wife]."

Finally, the distinction between enterprise and personal goodwill is just as susceptible to expert valuation as goodwill on the whole is, the court ruled, and held as a matter of law that trial courts should consider the distinction in divorce.

Court Frustrated by 'Hide the Ball' Tactics in Damages Discovery

***Kingsway Financial Services, Inc. v. PricewaterhouseCoopers LLP*, 2008 WL 5336700 (S. D. N.Y.)(Dec. 22, 2008)**

A lawsuit is not a game but a search for the truth. The ends of justice are served, not by giving one side a vested right to exhaust the other, but by affording both an equal opportunity to a full and fair adjudication on the merits.

Polaroid Corp. v. Casselman, 213 F. Supp. 379, 381 (S.D.N.Y. 1962)

The *Kingsway* court quoted this older case when deciding whether to impose discovery sanctions on the plaintiffs in their suit against PricewaterhouseCoopers

(PwC) for securities fraud and conspiracy. The plaintiffs claimed that from 1999 to 2002, the defendants inflated the value of company to induce their purchase of stock. However, in the long litigation that ensued—spanning more than four years—the plaintiffs refused to provide a detailed description of how they and their experts would calculate damages, which allegedly amounted to over $205 million.

A costly and contentious discovery. For example, in PwC's first set of interrogatories, they asked the plaintiffs to identify the category of damages sought and their calculation, plus supporting documents and witnesses. In a court conference, the plaintiffs explained that they did not want to disclose these items. *Why?* They were concerned that damages calculations might change during discovery and how they might give defendants a "roadmap" by which to plan their trial strategy.

The court directed the plaintiffs to answer the discovery requests pursuant to the applicable federal rules. The plaintiffs complied, to a certain extent. Their response detailed their damages calculations, including breaking them into nine categories (e.g., $50.4 million lost due to materially understated reserves; $107.4 million lost due to increased cost of capital), and they designated three witnesses with knowledge of these numbers. Nonetheless, when the defendants deposed one of them, the witness acknowledge knowing little about the damages component, including not even realizing any adverse consequences to plaintiffs' capital reserves.

The defendants moved for sanctions, including a request for the "ultimate" penalty of default judgment. The court clearly expressed frustration with the unnecessary costs and conflict:

> The defendants…should not have been forced to spend hours at a deposition attempting to discover which specific transactions out of the larger universe of facts underlying the nine damage categories were within [the witness's] knowledge. … By naming [the witness] as one of three witnesses with the most knowledge regarding each component of these damage calculations, when she lacked any knowledge regarding several of the damage categories, plaintiffs made it impossible for defendants to tailor their deposition question to [the witness's] expertise and therefore unnecessarily and vexatiously delayed discovery.

The court declined to dismiss the case, however, and instead ordered the plaintiffs to pay the defendants' fees and costs in taking thedeposition.