Litchfield Revisited: Post Valuation Appreciation of S Corporation Stock Should Not Be Included in Built-in Gain Discount

Karl A. Iverson Kaufman, Esq.

The fair market value of S corporation stock is often fiercely contested between the Internal Revenue Service and the taxpayer in gift tax and estate tax controversies. Valuation discounts (such as a discount for lack of ownership control, a discount for lack of marketability, and a discount for built-in capital gains) are particularly contested. This is because small changes in the amount of the discount can have a material impact on the value of the S corporation stock. In the Estate of Litchfield*, the Tax Court allowed a built-in gains (BIG) discount for both (1) unrealized appreciation and (2) future appreciation in a recently converted S corporation. In this discussion, the author argues that (1) a discount for unrealized appreciation is appropriate and (2) a discount for future appreciation is not appropriate.*

Introduction

In *Estate of Litchfield*,[1] the Tax Court allowed a federal estate tax valuation discount for C corporation stock and certain S corporation stock to reflect the impact of the built-in capital gains (BIG) tax. The Tax Court reasoned that a hypothetical willing seller and willing buyer would reduce the price of C corporation and certain S corporation stock by (1) taking into account the BIG tax on future appreciation of the underlying assets (with the appreciation occurring after the valuation date) and (2) reducing that expected BIG tax liability to present value.

In a recent article, Professor Bogdanski criticized the *Litchfield* decision for overstating the BIG tax valuation discount with respect to C corporations. Bogdanski concluded that the Tax Court improperly accounted for the future appreciation of the corporation's assets projected to occur after the valuation date.[2] The *Litchfield* decision's future appreciation methodology can also be criticized with respect to its treatment of recently converted S corporations.

After a C corporation converts to an S corporation, the corporation is subject to a corporate-level tax on "net recognized built-in gains" that are attributable to when it was a C corporation and are recognized during a 10-year "recognition period."[3] However, the amount of BIG recognized on the disposition of an S corporation asset is limited to the amount of unrealized appreciation in the asset (the excess of the asset's fair market value over its adjusted basis) immediately after the conversion.

Gain attributable to future appreciation (appreciation occurring after the valuation date) necessarily results in overstating the valuation discount. Accordingly, the *Litchfield* future appreciation methodology results in overstating the BIG tax discount with respect to an S corporation.

Background

The value of the gross estate includes the value of "all property, real or personal, tangible or intangible, wherever situated."[4] The value of property is a hypothetical price "at which such property would change hands between a willing buyer and a willing seller."[5] The hypothetical price is determined through a commonsense application of all the relevant facts and circumstances with appreciation that valuation is not an exact science.[6]

The valuation of property involves a fact-based inquiry that should take into account "all relevant facts and elements of value as of the time of the gift."[7]

The valuation of closely held corporate stock is generally a two-step process. First, valuation analysts estimate the value of the corporation—usually some combination of book value, asset value, capitalization of future earnings, or capitalization of future dividends. After the corporation's value is estimated, the per share value is then adjusted to reflect various discounts, such as lack of control, lack of marketability, and BIG tax liability.

When valuing stock in closely held real estate holding companies and investments companies, the net asset valuation method is generally the preferred valuation method.[8]

Under normal circumstances, a hypothetical willing buyer and willing seller do not discount an asset's value for unrealized appreciation in the asset. This is because the buyer takes a basis equal to "the cost of such property."[9]

The circumstances are different, however, where (1) the valued asset is stock in a corporation and (2) the corporate assets contain unrealized appreciation. In that case, the buyer will take the stock subject to the potential BIG tax liabilities, and the buyer would likely require the stock price to be discounted to reflect those tax liabilities.[10]

Valuation discounts for the stock of a corporation holding assets with BIG tax liabilities became relevant after the repeal of the *General Utilities* doctrine. At first, the Service focused on arguing that BIG tax valuation discounts should not be allowed at all. This was because the prospective liquidation test and the S corporation election could allow the corporation to avoid tax liability.

However, in *Estate of Davis*,[11] and *Eisenberg v. Commissioner*,[12] the Tax Court and the Second Circuit ultimately determined (1) that the potential BIG tax liability reduced the fair market value of stock and (2) that a BIG valuation discounts could be allowed as a matter of law. The Service quickly acquiesced to *Eisenberg*, conceding that "a discount for the built-in capital gains tax liabilities could apply depending on the facts presented."[13]

In *Litchfield*, the Tax Court correctly allowed a BIG tax valuation discount for unrealized appreciation in a recently converted S corporation. However, by including future appreciation (appreciation after the valuation date) in determining the amount of the discount, the Tax Court either overstated—or added an unnecessary step in determining—the valuation discount.

Background of the Case

In *Litchfield,* the Tax Court allowed a 17.4 percent BIG tax valuation discount for unrealized appreciation in a recently converted S corporation. The Tax Court reasoned that the proper discount for built-in gains was the present value of the taxes that Litchfield Realty Co. (LRC), a recently converted S corporation, would have to pay when it sold its assets. That liability included taxes attributable to asset appreciation occurring after the valuation date.

The Litchfield family formed LRC in 1921 as a C corporation to manage Iowa farmland. Litchfield family members contributed the farmland in return for shares of LRC stock. LRC leased its farmland to farmers, managed a portfolio of marketable securities, and owned a subsidiary that, among other things, operated a public grain elevator.

In January 2000, because LRC management believed pass-through taxation would result in better shareholder returns, LRC elected to convert from a C corporation to an S corporation.

Marjorie Litchfield, the decedent, died in April 2001 holding a 43.1 percent noncontrolling interest in LRC. As of the valuation date, LRC had a net asset value of $33,174,196, which included $28,762,306 of built-in capital gains (approximately 87 percent of LRC's net asset value).

Before discounts, the estate's valuation analyst applied the net asset valuation method to value the

> **"While a BIG tax valuation discount is appropriate in valuing recently converted S corporations, it is not appropriate to include in the discount the present value of appreciation occurring after the valuation date."**

decedent's minority interest at $14.3 million. The valuation analyst then discounted the LRC interest for, among other things, the BIG tax liability.

To determine the amount of the BIG discount, the estate's valuation analyst (1) examined the LRC historical and recent data and (2) had conversations with LRC management to project the number of years from the valuation date that LRC would hold its assets before selling. The analyst then estimated appreciation of the LRC assets during the projected holding period.

Based on the estimated asset value at the projected sale date, the estate's valuation analyst then calculated the total amount of S corporation BIG tax it would pay, and reduced that amount to a present value. On audit, the Service's valuation analyst discounted the decedent's interest by only 2 percent for the corporation's BIG tax liability. The Service assessed an estate tax deficiency, and the estate filed a Tax Court petition.

The Tax Court allowed the estate's full 17.4 percent BIG valuation discount. The court reasoned that:

> . . . as of the valuation date, a hypothetical buyer of LRC and LSC[14] stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in the built-in capital gains discount that would be negotiated between the hypothetical buyer and seller.

Accordingly, the Tax Court adopted the estate's future appreciation methodology and allowed the valuation discount.

Issues in the Case

A BIG tax valuation discount is appropriate in valuing recently converted S corporations. However, it is not appropriate to include in that discount the present value of appreciation occurring after the valuation date. Unlike a C corporation, an S corporation generally pays no corporate-level tax. Instead, items of income and loss pass though to the S corporation's shareholders. Each shareholder separately takes into account his or her share of those items.[15]

However, after a C corporation converts to an S corporation, it is subject to a corporate level tax at the highest marginal rate on "net recognized built-in gains" that:

1. are attributable to when it was a C corporation and
2. are recognized during a 10-year "recognition period" (the S corporation BIG tax).[16]

The recognition period is a 10-year period beginning the first day that the corporation is an S corporation.[17]

Net Recognized Built-in Gain

The S corporation BIG tax applies to any S corporation that has a "net recognized built-in gain" for any year during the recognition period. Net recognized built-in gain is based on the amount of recognized built-in gains and losses. Specifically, the net recognized built-in gain for a year is the lesser of the following three amounts:

1. The corporation's taxable income for the year computed as if it were a C corporation but taking into account only recognized built-in gains and losses[18]
2. The corporation's taxable income for the year computed as if it were a C corporation but without taking into account the dividend received deduction or net operating loss deduction[19]

3. The total amount of unrealized appreciation in the assets immediately after conversion from a C corporation to an S corporation reduced by the amount of recognized built-in gain from all prior years (the net unrealized built-in gain limitation)[20]

Exhibit 1
Illustrative Property Value and Related BIG Tax

Year of Sale	FMV	Adjusted Basis	Gain	Tax on Gain	Present Value
0	$200.00	$100	$100.00	$40.00	$40.00
1	220.00	100	120.00	48.00	45.28
2	242.00	100	142.00	56.80	50.55
3	266.20	100	166.20	66.48	55.81
4	292.82	100	192.82	77.13	61.09
5	322.10	100	222.10	88.84	66.39

The third limitation, the Section 1374(c)(2) net unrealized built-in gain limitation, provides a ceiling on the total amount of built-in gain that can be subject to the S corporation BIG tax.[21] Thus, the amount subject to the S corporation BIG tax for each year is based on the amount of recognized built-in gains for that year.

Recognized Built-in Gains

Gain on a sale, exchange, or other disposition during the recognition period is recognized built-in gain, unless the corporation establishes that one of these three limitations applies:

1. First, gain is not recognized built-in gain if the S corporation shows it was recognized on disposing of property it did not own at the beginning of the recognition period.[22]
2. Second, gain is not recognized built-in gain if the S corporation shows that there was no unrealized appreciation in the property at the start of the recognition period (i.e., the property's fair market value did not exceed its adjusted basis).[23]
3. Finally, recognized built-in gain is limited to the amount of unrealized appreciation in the property at the beginning of the recognition period.[24] In other words, the recognized built-in gain is limited to the excess of the property's fair market value over its adjusted basis at the beginning of the recognition period.

It is the third limitation that renders the Tax Court's future appreciation methodology incorrect. If recognized built-in gain is limited to the amount of unrealized appreciation in an asset at the beginning of the recognition period, and the valuation date is after conversion but within the recognition period (as it must for the S corporation BIG tax to apply), then future asset appreciation is, necessarily, appreciation in excess of the limit imposed by Section 1374(d)(3)(B).

Therefore, the Tax Court's future appreciation methodology is inconsistent with the operation of Section 1374.

Illustrative Example

Let's consider the following example. Let's assume that a C corporation owns undeveloped land known as Greenacre. In year 0, when the Greenacre fair market value is $200 and its adjusted basis is $100, the C corporation converts to an S corporation. The Greenacre value is projected to increase 10 percent each year, and Greenacre is expected to be sold within the next five years. Let's assume a federal and state corporate income tax of 40 percent, and a discount rate of 6 percent.

Under the Tax Court methodology, the value of the discount equals the present value of the projected amount of built-in gain taxes. That amount will change depending on the appreciation and discount rates, as presented in Exhibit 1.

However, as stated above, Section 1374(d)(3)(B) limits the amount of recognized built-in gain to the excess of the property's fair market value over its adjusted basis immediately after the conversion (in year 0). The appropriate valuation discount should be limited to $40. That amount should then be discounted to present value based on the projected turnover, as presented in Exhibit 2.

Accordingly, the BIG tax valuation discount should be based on the present value of the S corporation's BIG taxes without taking into account any future appreciation.

Exhibit 2
BIG Tax Valuation Discount Estimate

Year of Sale	FMV	Adjusted Basis	Gain	Recognized BIG[25]	Tax on Gain	Present Value
0	$200.00	$100	$100.00	$100.00	$40.00	$40.00
1	220.00	100	120.00	100.00	40.00	37.74
2	242.00	100	142.00	100.00	40.00	35.60
3	266.20	100	166.20	100.00	40.00	33.58
4	292.82	100	192.82	100.00	40.00	31.68
5	322.10	100	222.10	100.00	40.00	29.89

Summary and Conclusion

In *Litchfield*, the Tax Court correctly allowed a valuation discount for S corporation BIG tax liability during the recognition period. That judicial decision may be criticized, however, for reasoning that a hypothetical seller would take into account the present value of any future appreciation in determining the amount of the BIG tax valuation discount.

Notes:

1. Estate of Litchfield, TC Memo 2009-21, 2009 TCM (RIA) ¶ 2009-021.
2. Bogdanski, "Discounts for 'Built-in' Gain Taxes: The *Litchfield* Fallacy," 37 *Estate Planning* 37 (June 2010).
3. IRC § 1374(a).
4. IRC § 2031(a).
5. Treas. Reg. § § §20.2031-1(b).
6. Rev. Rul. 59-60.
7. Id.
8. Estate of Smith v. Commissioner, 1999 TCM (RIA) ¶96,057; Rev Rul 59-60 § 5(b).
9. IRC § 1012.
10. See, e.g., Estate of Davis, 110 TC 530 (1998); Eisenberg v. Commissioner, 155 F.3d 50 (2nd Cir 1998).
11. 110 TC 530 (1998).
12. 155 F.3d 50 (2nd Cir 1998).
13. AOD 1999-001.
14. LSC refers to Litchfield Securities Co., a C corporation.
15. IRC § 1366.
16. IRC § 1374(a).
17. IRC § 1374(d)(2)(A)(i). For tax years beginning in 2009 and 2010, the recognition period is reduced to seven years and for a tax year beginning in 2011, the recognition period is reduced to five years, with the recognition period beginning on the first day of the first tax year for which the corporation was an S corporation. IRC § 1374(d)(7)(B).
18. IRC § 1374(d)(2)(A)(i).
19. IRC § 1374(d)(2)(A)(ii).
20. IRC § 1374(c)(2).
21. Net recognized built-in gain is limited to the excess of the "net unrealized built-in gain" over the sum of the net recognized built-in gains for all prior years. IRC § 1374(c)(2). The net unrealized built-in gain amount is the excess of the corporation's total asset value over the corporation's aggregate basis in its assets at the beginning of the recognition period. IRC § 1374(d)(1). Thus, the total amount subject to S corporation BIG tax for all years is the net unrealized built-in gain at the beginning of the recognition period.
22. IRC § 1374(d)(3)(A).
23. IRC § 1374(d)(3)(B).
24. IRC § 1374(d)(3)(B), see Garwood Irrigation Co. v. Commissioner, 88 TCM (CCH) 173 (2004).
25. IRC § 1374(d)(3)(B).

Karl A. Iverson Kaufman is an associate at Thede Culpepper Moore Munro & Silliman in Portland, Oregon. Karl practices in the areas of estate planning, business taxation, and tax-exempt organizations. Karl received his J.D. from the University of Oregon School of Law (Order of the Coif, 2007) and his Master of Laws in Taxation from New York University School of Law (2010), where he was a graduate editor of the Tax Law Review *and awarded the Wilf Tax Scholarship, one of the school's top merit scholarships. Karl can be reached at karl.kaufman@thede-culpepper.com.*