MESSAGE FROM THE CHAIR

Dear Fellow Members:

As members of the Trusts and Estates Section of the Virginia State Bar, we have the good fortune to provide legal services to clients who seek guidance on how to dispose of assets that they have worked a lifetime to accumulate so as to positively affect the lives of the people who are most dear to them. In providing this guidance, many of us enjoy a very special type of job satisfaction.

As estate planners, many of us consider ourselves to be tax practitioners. Perhaps too often, we view the minimization of transfer taxes as the most important goal that we can achieve for our clients. Because the amount of tax can be easily quantified, the effect that planning can have on taxes can easily become the focus of our discussions with our clients. Although tax planning is very important, few of our clients would choose a plan that guaranteed zero taxes over a plan that guaranteed happiness and security for their loved ones.

Recent serious consideration of estate tax repeal has led to predictions that our estate planning practices might change significantly. If the repeal efforts bear fruit, we can expect to have more opportunities to help our clients to achieve the less quantifiable but critically important goals that can easily be overlooked when the estate tax looms on the horizon. This shift in focus should prove beneficial to our clients and rewarding for us. In fact, it may prove to be more valuable to many of our clients than the promised tax savings.

Regardless of the outcome of the estate tax repeal debate, I remain optimistic about our practice area and grateful for the opportunity to be of service to clients. I am also grateful to the authors who have contributed to this newsletter and to Phil Stone for his efforts as the editor of the Newsletter.

Sincerely,

Timothy H. Guare

*Editor’s Note: On May 26, 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001, which reforms and ultimately repeals the gift and estate tax by 2010. The Act was signed by President Bush on June 7, 2001.

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Overview of Grantor Retained Annuity Trusts (GRATs)

By Dennis I. Belcher and Kyle C. Harrison

Introduction.

A Grantor Retained Annuity Trust ("GRAT") is one of the estate planning techniques based primarily on interest rate assumptions. Clients create GRATs using assets that are likely to earn more than the Internal Revenue Service's measuring standard (the section 7520 interest rate) during the GRAT term in an effort to pass the appreciation in the assets to the beneficiaries of the trust free of gift and estate tax.

Description of GRAT Technique.

A grantor creates a GRAT by transferring assets to an irrevocable trust for the benefit of one or more noncharitable beneficiaries and retains an annuity interest for a term of years. For transfer tax valuation purposes, the amount of the taxable gift is the fair market value of the property transferred minus the value of the grantor's retained annuity interest. At the end of the term reserved by the grantor, the trust assets are distributed to the beneficiaries selected by the grantor. If the grantor dies during the GRAT term, the value of the remainder interest in the trust is included in the grantor's taxable estate under either section 2036 (retained income, possession, or enjoyment of property) or 2039 (retained right to receive annuity in transferred property).

If the trust instrument meets the requirements of section 2702, the IRS assumes that the trust assets will produce a return equal to the section 7520 rate applicable to the month of transfer. The annuity amount is paid to the grantor during the term of the GRAT, and any property remaining in the trust at the end of the GRAT term passes to the beneficiaries with no further gift tax consequences. Thus, if the GRAT assets produce a return in excess of the 7520 rate, the increase in value above the section 7520 rate is passed to the beneficiaries free of gift tax. The actuarial value of the amount of the remainder interest passing to the beneficiaries of the GRAT upon its termination is a gift to the remainder beneficiaries subject to gift tax.

If the GRAT is structured so that the retained annuity's actuarial value is almost equal to the value of the property transferred, there is little gift tax consequence. If the grantor lives out the term, the remainder passes to the beneficiaries without any additional transfer tax. If the grantor receives annuity payments in an amount equal or almost equal to the value of the property transferred, the only value removed from the grantor's taxable estate is the growth, if any, in the value of the transferred property in excess of the section 7520 rate.

The following is an example of the valuation rules of a GRAT. Assume that a parent funds an irrevocable trust with $1,000,000. Under the terms of the trust, parent receives an annual annuity for 10 years of $50,000. If the section 7520 rate is 8.0 percent, the value of parent's retained interest is valued at $313,940 and the remainder interest is valued at $686,060. Thus, the right to receive a $50,000 annuity for 10 years is worth $313,940 and the right to receive the remainder at the end of 10 years is worth $686,060. The value of the remainder interest, $686,060, would be subject to gift tax upon creation of the GRAT.

The purpose of the rules applicable to GRATs promulgated by the Internal Revenue Service is to prevent the shifting of economic enjoyment between income and remainder beneficiaries based on investment decisions.
made by the trustee. The grantor is entitled to receive the annuity regardless of the income produced by the trust assets. Accordingly, a trustee would have no incentive to maximize principal growth at the expense of income. The trustee’s objective is to maximize the total return of the trust assets regardless whether it is from income or appreciation.

**Governing Instrument Requirements of a GRAT.**

The most important element in structuring a GRAT is to make sure that the governing instrument (irrevocable trust) meets the requirements of section 2702 so that the grantor’s retained interest may be subtracted in determining the grantor’s gift to the remainder beneficiaries. Otherwise, the grantor’s retained interest is valued at zero and the gift made by the grantor to the remainder beneficiaries is the entire value of the trust assets.

Under section 2702, a “qualified interest” is valued under section 7520. If the grantor retains an interest that is not a qualified interest or does not meet one of the exceptions to section 2702, the retained interest is valued at zero. Thus, if the requirements of section 2702 are not met, a GRAT could result in a taxable gift equal to the entire value of the trust assets regardless of the interest retained by the grantor.

Section 2702(b) defines a “qualified interest” to be:

1. Any interest which consists of the right to receive fixed amounts payable not less frequently than annually, and

2. Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually).

The term of the annuity in a GRAT must be a fixed amount of time equal to the life of the annuitant, a specified term of years, or the shorter of those two periods.

**The Annuity Amount of a GRAT.**

The trust instrument must require that the annuity amount be payable to the holder of the annuity interest at least annually. The annuity payment may be based on the taxable year of the trust or may be based on the anniversary date of the trust. If the payment is made on the anniversary date, proration of the annuity amount is required only if the last period during which the annuity is payable to the grantor is a period of less than 12 months. If the annuity payment is based on the taxable year, proration of the annuity amount is required for each short taxable year of the trust during the grantor’s term. The prorated amount is the annual annuity amount multiplied by a fraction, the numerator of which is the number of days in the short period and the denominator of which is 365 (or 366 if the proration occurs during a leap year).

The annuity must be paid to the grantor regardless whether the trust has produced income equal to the annuity. If trust income is insufficient, the trustee must be required to invade principal to pay the annuity. A note, other debt instrument, option, or similar financial arrangement may not be used, directly or indirectly, to pay the annuity amount. Therefore, the assets in the GRAT must produce a sufficient annual cash flow to pay the annuity amount, or must be sufficiently liquid that the trustee can sell or distribute a portion of the assets each year to satisfy the annuity amount.

If a grantor's annuity payment is based on the anniversary date of the trust, it must be paid no later than 105 days after the anniversary date. An annuity payment based on the taxable year of the trust may be paid in the subsequent year as long as the annuity is paid by the date on which the trustee must file the income tax return for the trust determined without regard to extensions. The trust instrument must require that the trustee actually pay the annuity amount to or for the benefit of the grantor and it is not sufficient for the grantor to have the annual right to withdraw the annuity amount.
The annuity amount must be a fixed amount expressed either in the terms of a fixed dollar amount or a fixed percentage of initial fair market value of the property transferred to the trust as finally determined for federal tax purposes. By expressing the annuity in terms of a formula, it is possible to minimize gift tax exposure. Under the IRS Regulations, the fixed amount does not have to be the same amount for each year. But, variations in the annuity amount from year to year may not exceed 120 percent of the amount payable in the previous year. If the trust property will appreciate over the term of the trust at a uniform rate, increasing annuity payments will produce more value for the beneficiaries at the end of a term than would constant annuity payments.

An example of a qualified payment in a GRAT is as follows. Parent transfers 100 shares of Good's Transfer, Inc. to a three-year GRAT. Under the terms of the trust, the trustee is to pay parent an annuity equal to 10 percent of the initial value of the trust assets in the first year with the annuity payment increasing 20 percent in the second year and 20 percent in the third year. In each case the value is to be the value as finally determined for federal gift tax purposes. After the third payment has been made to parent, the trustee is to distribute the remaining trust assets to child.

Under the IRS Regulations, the trustee may distribute amounts in excess of the annuity amount to the grantor. The value of rights to receive payments in addition to the qualified annuity interest has a zero value for gift tax purposes. The Regulations require that the trust instrument contain a provision requiring adjustment to annuity payments previously made if an error was made by the trustee in determining the annuity amount.

The trust instrument must prohibit:

1. Additional contributions to a GRAT.

2. Commutation, or the prepayment by the trustee of the grantor’s annuity interest.

The purpose of prohibiting commutation is to prevent termination of a GRAT when the grantor’s life expectancy is short. If a grantor dies during the term of the GRAT, a portion of the GRAT will be included in the grantor’s estate under section 2036. This amount could be reduced if the trustee could terminate the GRAT before the grantor’s death by paying the grantor an amount equal to the actuarial value of the grantor’s remaining interest and delivering the balance of the trust assets to the remainder beneficiaries.

3. Payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant.

4. For trusts created on or after September 20, 1999, issuance of a note, other debt instrument, option, or similar financial arrangement in satisfaction of the annuity payment obligation.

**Zeroed Out GRAT.**

A zeroed-out GRAT is a GRAT in which the value of the grantor’s retained interest is equal to the value of the property transferred to the trust, resulting in a remainder (and a gift-tax value) of zero.

Under IRS Regulation Section 25.2702-3(e), Example 5, the computation of the taxable gift made upon creation of a GRAT always has a mortality component. In such case, the value of the GRAT remainder could never be "zeroed out" (have a value of zero) and thus not result in a taxable gift -- even where the annuity was payable for a fixed term without a reversionary interest and was expected to exhaust the trust principal by the end of the term under IRS annuity valuation tables. A recent decision of the United States Tax Court, Walton v. Commissioner, 115 T.C. 41 (2000), appears to resolve the question of whether a zeroed out GRAT is possible. Before Walton, IRS Regulations provided that even if a grantor
retained the right to receive an annuity over a fixed term in a GRAT, the value of the qualified annuity interest was determined as though the right to the annuity was retained for the shorter of the fixed term or until the grantor's death. Pre-Walton, the right to receive an annuity for the shorter of an individual's life or a fixed term was considered by the IRS to be worth less than the right to receive an annuity for the entire fixed term. The IRS allowed the retained annuity interest to be valued only if the grantor would receive it during life. Any interest that would pass to the grantor's estate if he or she died during the term of the GRAT would not be included in the value of the retained annuity interest. Therefore, the amount of the annuity was reduced by the probability of the individual's death before the end of the term and that amount is considered a remainder interest taxable as a gift to the remainder beneficiaries.

Under Walton, the value of an annuity payable over a term to the grantor and to the grantor's estate if the grantor dies during the GRAT term is not reduced by the value of the contingent interest that the grantor's estate if the grantor dies during the GRAT term because a fixed annuity payable to the grantor or the grantor's estate does constitute a "qualified interest" under section 2702. Therefore, a fixed GRAT period may be established in the trust document that will not terminate if the grantor dies during the GRAT term. A GRAT that pays the annuity amount to the grantor during his or her lifetime and to his or her estate if the grantor dies during the term of the GRAT will be included in the value of the retained annuity interest. This removes the decrease previously required to be made to the retained interest to account for the possibility of the grantor's death during the term and allows the GRAT to be zeroed out leaving a remainder of zero. It should be noted that the Internal Revenue Service has not acquiesced in the Walton decision and thus its position on this issue remains uncertain.

**Transfer Tax Aspects of GRATs.**

Under section 2702(a)(2)(B), the value of a qualified annuity interest is determined under section 7520. Thus, the value of a gift to a GRAT will be determined by subtracting from the value of the assets transferred to the GRAT an amount equal to the actuarial value of the retained annuity. If the annuity would exhaust the trust funds before the last annuity payment is to be made, the annuity is not considered payable for the entire period.

A GRAT is a more attractive technique when the section 7520 rate is low. As the section 7520 rate decreases, the value of the retained interest in a GRAT will increase. This occurs because a decrease in the assumed rate of return makes the right to receive fixed amounts in the future more valuable. Because the grantor may use a valuation formula, a GRAT allows the grantor to transfer a difficult to value asset without a significant risk of unexpected gift tax.

The following is an example of how a valuation formula will reduce the risk of unexpected gift tax consequences when dealing with hard to value assets. In January 2000, assume parent, age 60, transfers 100 shares of common stock in Good's Transfer, Inc., a corporation taxed as an S corporation, to a GRAT. Good's Transfer has 200 shares outstanding and the value of the entire company is $1,000,000. Under the terms of the GRAT, parent retains an annuity of 15 percent, increasing by 20 percent annually, for five years, with the remainder interest passing to parent's children. Parent files a gift tax return showing a transfer of $300,000 to the GRAT ($1,000,000 x 50 percent ownership less a 40 percent discount), with a gift of $44,872.50 to Sarah, Matt, and Ben. If on audit the Internal Revenue Service allows only a 20 percent discount, the taxable gift would be $59,830. Thus, an increase in the amount transferred by $100,000 increases the taxable gift by approximately $15,000.
There should be no gift tax consequences upon the termination of the GRAT. Because the grantor's gift was complete for gift tax purposes when the trust was created, the trust assets remaining in the GRAT upon the expiration of the annuity term are paid to the remainder beneficiaries without any additional gift tax imposed on the grantor. If the trust property generates income and appreciation in excess of the section 7520 rate used to value the annuity interest when the GRAT was created, property will be transferred to the remainder beneficiaries without being subject to gift tax.

If the grantor dies during the term of the GRAT and has the right to receive further annuity payments, a portion of the GRAT will be included in the grantor's gross estate for federal estate tax purposes. The value of property transferred during the transferor's life is included in the transferor's gross estate if the transferor retained for life or for a period that did not end before the transferor's death, the right to receive the income from the transferred property.

Under a GRAT, the grantor does not explicitly retain the right to receive income; rather, the grantor retains the right to an annuity. The Internal Revenue Service treats an annuity as if it were the right to receive the income from a portion of the principal of the trust. The included portion is that fraction of the trust which would be required to be invested at the section 7520 rate in effect on the date of the grantor's death to produce income equal to the required annuity payment.

A GRAT is not an appropriate device to use in a generation-skipping transfer. The transfer of assets to a GRAT is a transfer to a trust and not to a grandchild. The generation-skipping transfer occurs when the grantor's interest in the GRAT terminates. Thus, GST exemption must be applied when the GRAT terminates and the ability to leverage the client's GST exemption is lost.

If the grantor dies during the GRAT term and the right to the remaining annuity payments passes to a surviving spouse, in order to ensure that the value of the remaining annuity interest qualifies for the estate tax marital deduction under section 2056, the grantor's estate planning documents should provide that if the grantor's spouse survives the grantor, the annuity payments will either (1) pass outright to the surviving spouse or her estate or (2) pass to a marital trust over which the spouse has a general power of appointment.

**Income Tax Consequences of a GRAT.**

If a trust is classified as a "grantor trust," the grantor of the trust must report all items of income and deductions from the trust assets. If the grantor retains an annuity interest worth more than five percent of the value of the trust assets, the trust will be classified a grantor trust for federal income tax purposes. A trust may be a grantor trust for some (for example income only and not principal) or all purposes. If a trust is classified as a grantor trust for all purposes, all items of the trust's income, deduction, and credits are reported by the grantor in calculating the grantor's income tax liability, regardless of the distributions to the grantor from the trust.

A GRAT should typically be structured to be a grantor trust for both principal and income purposes. This provides several benefits. First, if the GRAT is a grantor trust for all purposes, the GRAT may be a shareholder in an S corporation. Next, if the GRAT is grantor trust for all purposes, transactions between the grantor and the trust are ignored. Thus, no gain or loss is recognized when the grantor sells assets to a GRAT, or the GRAT sells assets to the grantor.

It may not be safe to rely on the annuity payment provisions for the GRAT to be classified as a grantor trust. Generally, the estate planner should insert special provisions in the GRAT to ensure that the GRAT will be classified as a grantor type trust for all purposes.

**Situations Where a GRAT Should Be Considered.**

1. **Leverage Unified Credit Gift With No**
Downside Risk. A GRAT allows a client to leverage transfers to children. As long as the asset appreciates more than the section 7520 rate, the children win. If the asset does not outperform the section 7520 rate, then the client receives back the asset with no tax repercussion.

2. Client Has Made Unified Credit Gift and Does Not Want to Pay Gift Tax. Some clients have made unified credit gifts and are reluctant to make additional gifts because of the aversion to paying gift tax. The client in this situation should consider a zeroed-out GRAT. A zeroed-out GRAT does not result in a taxable gift to the remainder beneficiaries and the client does not pay gift tax. If the trust assets outperform the section 7520 rate, the client has made a transfer to children or other beneficiaries outside the transfer tax system.

3. Asset With Significant Appreciation Potential in Short-Term. A GRAT may be an ideal vehicle for the transfer of significant appreciation on an asset. Assume the client owns an interest in a business that may go public in the near future. If the client transfers the business interest to a short-term zeroed-out GRAT, most of the appreciation will be transferred tax free. If the client has more than one asset with this potential, it is wise to use a separate GRAT for each asset so as not to dilute the appreciation. An example of an excellent asset to transfer to a GRAT is an interest in a racehorse before the horse has success on the track.

4. Client Has Portfolio That Will Outperform the Section 7520 Rate and Wants to Minimize Transfer Taxes. The key to using a GRAT to leverage transfers is selecting assets that will outperform the section 7520 rate. Since 1993, the section 7520 rate has ranged from a low of 5.6 percent to a high of 9.6 percent. During that same time period there have been numerous security issues trading on national exchanges that have far exceeded the section 7520 rate. If a client, age 60, had transferred a $1,000,000 portfolio of securities to a three-year GRAT, with a 30 percent annuity increasing 20 percent annually in November of 1993 (the section 7520 rate was 6.0 percent), and the securities increased 30 percent annually the results would be as follows. The grantor's retained annuity interest was valued at $944,280 and the taxable gift to the remainder beneficiaries was $55,720. Until the GRAT terminated in September of 1996, the grantor received annuity payments totaling $1,092,000. The remainder beneficiaries received $870,048. A gift of $55,720 was leveraged to $870,048.

Conclusion.

The potential transfer tax advantages of a GRAT derive from the assumptions used to value the income and remainder interests under section 7520. In determining the present value of the split interests, section 7520 assumes that the transferred property will produce income equal to a prescribed interest rate and the principal value of the property will not increase or decrease.

If the total of the income and appreciation from the property is greater than the section 7520 rate, the remainder interest will have been undervalued for federal transfer tax purposes and any excess value passes to the remainder beneficiaries free of transfer tax. If the income and appreciation from the property do not outperform the section 7520 rate, the taxable gift is greater than the remainder interest passing to the remainder beneficiaries. If the GRAT is structured so that the remainder interest is relatively small, the downside of a GRAT is slight and the upside is large.

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ENDNOTES

1 All section references are to sections of the Internal Revenue Code of 1986, as amended.
2 Treas. Reg. § 25.2702-3(b)(1).
3 Treas. Reg. § 25.2702-3(b)(3).
4 Id.
6 See Howard M. Zaritsky, Y2K—A Vantage Year for GRATs, 28 Estate Planning 144 (March 2001).
8 Id.
11 Id.
14 Treas. Reg. § 25.2702-3(b)(5).
18 Deborah V. Dunn, Coming to a Wal-Mart Near You: Tax-Free GRATs, Trusts & Estates (April 2001) p. 10, 12.
19 Treas. Reg. § 25.2702-3(e), Example (5).
20 I.R.C. § 2036.
21 I.R.C. §
22 Treas. Reg. § 1.671-3.
You can hardly pick up the paper or open your mail without seeing an advertisement for a living trust seminar. Writing a will "is one of the biggest mistakes" you can make. After all, a will is a "one-way ticket to probate." A living trust 1, on the other hand, ensures that your estate will transfer quickly and without the expense of probate. Neither the court nor disgruntled relatives can alter your plan. Your family, and not the probate court, will be in charge. With the magical living trust, all expensive court proceedings and delays are eliminated, your privacy is preserved and the emotional stress on your family is minimized.

Given these promises, it is almost embarrassing to let a client leave your office without one. Some may even consider it malpractice not to recommend a living trust. 2

Lost in all the hype is the fact that the probate process in Virginia is relatively straightforward and has a number of protections for family members, creditors and fiduciaries that are not available with a living trust. The delays, cost and litigation attributed to the probate system are more often caused by the composition of the estate, the claims made against it and the nature of the beneficiaries, than by the "out-dated" probate system. Advertisements and seminars notwithstanding, not everyone needs, or will benefit from, a living trust.

This article will examine some of the claims made in recent advertisements read and brochures received by the author promoting living trusts, and discuss some of the benefits of the probate process that neither the advertisements nor the brochures acknowledge.

**A Living Trust Reduces Taxes.** Promoters of living trusts used to assert that a living trust saved estate taxes. Now, that claim is implied rather than made directly: "If you are married and your estate is worth less than $1.35 million, there will be no federal estate taxes to pay with a living trust." Without a living trust, even if you have a will, "[i]f you are married and your estate is over $675,000 net, without proper planning your family may owe federal estate taxes of 37% - 55%.

Proper planning is needed to coordinate the unified gift and estate tax credit with the unlimited marital deduction. This planning, not the mere existence of a living trust, results in the estate tax savings. The living trust does not remove the assets from an individual's estate. 3 A married couple with an estate of $1.35 million or less, with proper planning, will pay no estate taxes whether a will or a living trust is used to dispose of their assets.

Before the Taxpayer Relief Act of 1997 income tax treatment of a decedent's estate was generally more favorable than income tax treatment for a trust after the grantor's death. The 1997 Act largely eliminated these differences. A personal representative may now elect to treat certain qualified revocable trusts as part of the decedent's estate for federal income tax purposes. However, certain differences remain that could be important in individual cases. For example, a personal representative may continue to hold the decedent's stock in an S corporation for a "reasonable period of administration." 4 A trustee may hold the S Corporation stock for only two years before post-death restrictions are imposed. 5
The only tax avoided, or minimized, in Virginia, by the use of a living trust is the probate tax. The probate tax in Virginia is one-tenth of one percent (.001) and is assessed against any assets held in the decedent's name alone. The probate tax does not apply to assets that pass automatically upon death including assets held jointly with right of survivorship or assets, such as life insurance and retirement plans, for which there is a designated beneficiary. The potential probate tax savings, as a general rule, do not make the case to use a living trust rather than a will.

**A Living Trust Avoids the Claims of Creditors.** Living trusts are sometimes promoted as a way to avoid creditors. The claim may be made explicitly (“you can avoid the claims of creditors”) or implicitly (“in probate the court orders your debts paid and possessions distributed according to state law, which may not be what you would have wanted”).

During the lifetime of the grantor, assets in a revocable trust are treated as owned by the grantor and are subject to his creditors. Upon death, the right of creditors, other than a surviving spouse or the Internal Revenue Service, to reach trust assets is not clear under Virginia law.

Virginia has several early cases in which wives, unsuccessfully, tried to claim their statutory share against the assets of a revocable trust. Virginia's augmented estate statute has now eliminated the use of living trusts as a mechanism to avoid claims of the surviving spouse.

Under federal tax law, the trustee can clearly be held liable for estate taxes. The personal representative has primary responsibility for the payment of taxes; however, any person in actual or constructive possession of the decedent’s property is treated as executor if none is appointed.

Some jurisdictions, by case law, allow unsecured creditors to reach assets in a revocable living trust after the grantor's death if the probate estate is insufficient to satisfy the creditors' claims. Other states have enacted legislation making the assets of revocable trusts subject to creditors' claims after death.

In what may be a sign of things to come, the Uniform Trust Code ("UTC") promulgated in 2000 by the National Conference of Commissioners on Uniform State Laws, and currently under consideration in the District of Columbia, makes the property of a revocable trust subject to the grantor's creditors upon the grantor's death. The assets of the trust may also be used for estate settlement costs, funeral expenses and statutory allowances to the extent that the grantor's probate estate is inadequate.

1. **Probate protects statutory allowances for the family.** Under Virginia law, a trustee has no obligation (or right) to pay the family allowance, exempt property or homestead allowance from the trust assets. In a probate estate, these claims are given priority over claims of the decedent's creditors. To claim the homestead allowance, the spouse or children must forego other benefits under the will or by intestate succession. Benefits from a funded trust apparently may be accepted in addition to the homestead allowance. These allowances currently total $32,000. Whether this is a "good" or "bad" difference between a will and a living trust depends upon your perspective.

2. **In some states, probate cuts off the claims of creditors.** The majority of states bar claims not filed or presented within a set period following some prescribed event, usually the publication of notice to creditors in the local newspaper. For example, in Maryland, except as otherwise provided by statute with respect to claims of Maryland or the United States government, all claims against an estate, on whatever legal basis, are forever barred against the estate, the personal representative and the heirs and legatees, unless presented within six months after the date of the decedent's death; or two months after the personal representative gives the creditor notice that his claim will be barred unless he presents the claim within 2
months from the mailing or other delivery of notice. In contrast, the statute of limitations for making a claim against a trust is three years.

The ability to cut off claims of creditors within a relatively short period of time presents a strong argument to use a will rather than a trust in such states.

3. Probate can protect the personal representative from future claims of creditors. Virginia does not require notice to creditors by publication except as part of the debts and demands procedure. The statute of limitations applicable to a particular claim applies even after death. However, the personal representative can protect himself from future claims of creditors by undertaking the debts and demands procedure followed by a Show Cause Hearing and Order of Distribution. If there are no objections at the Show Cause hearing, the court will enter an Order of Distribution directing payment, in whole or in part, with or without a refunding bond, as the Court determines, to “whomsoever the court has adjudged entitled thereto.”

A personal representative who makes distributions in reliance upon the Order of Distribution is fully protected against creditors and all other persons. The personal representative is protected “even if” the distribution is made prior to the expiration of one year from his qualification “against the demands of spouses, persons seeking to impeach the will or establish another will or purchasers of real estate from the personal representative.”

A trustee of a living trust does not have a similar procedure by which he can protect himself from future claims.

4. Probate protects the personal representative of an insolvent estate. As noted above, the allegation is that a probate court will order “your debts paid and possessions distributed according to state law, which may not be what you would have wanted;” whereas, with a living trust “[d]ebts are paid and possessions distributed to beneficiaries according to your written instructions.”

Most wills direct the personal representative to pay the debts and taxes of the estate. However, this “formal direction merely recites the duty which every executor has under the law.” Under Virginia law, if assets of a decedent “in the hands of his personal representative” are not enough to pay the demands against his estate, he is protected so long as he follows the order of priority and procedures set forth in the code. This statutory scheme does not apply to trusts. Arguably, in Virginia, the trustee has no duty to pay debts, but if he does, and the trust is insufficient to pay all of the grantor’s obligations, the trustee might well wish for the direction, and protection, afforded the personal representative by state law.

5. The living trust may actually create needless disputes over the source of payment for debts and bequests. Many living trusts contain language allowing the payment of taxes, bequests and expenses from the trust, for example: “At my death my Trustee may pay to or upon the order of my Personal Representative funds needed to pay my debts, funeral and burial expenses, costs of administration and specific bequests under my will.”

This language may or may not be helpful to the trustee and/or the grantor’s beneficiaries. What does the trustee do when the beneficiaries under the will and the beneficiaries under the trust are different? Does the trustee exercise the discretion to pay expenses? To pay bequests? What about the trustee’s duty to the beneficiaries of the trust? Distributions from the trust to pay expenses would reduce the amount that would otherwise pass to the trust beneficiaries. Yet, if the trust mandates these payments (“my Trustee shall pay”), any possible creditor protection would be lost.

Where discretion is conferred upon the trustee with respect to the exercise of a power, the trustee’s exercise is not subject to control by the court, except to prevent the abuse by the
trustee of his discretion.24 Yet, if the trustee pays creditors’ claims from trust assets without adequate legal authority, the trustee could be held responsible to the injured party, whether a beneficiary or a creditor.25

Rather than avoiding the claims of creditors, the living trust might actually increase the confusion, and thus the cost and delay, of making final distribution until competing claims can be resolved, in all likelihood, through a court proceeding.

**A Living Trust Avoids the Cost and Delay of Probate.** The costs and delays associated with probate are often greatly exaggerated. The basic administration requirements are the same whether a personal representative or a trustee is administering an estate or trust. The decedent's assets must be marshaled and inventoried, his debts ascertained and paid, taxes calculated and returns prepared, and the remaining assets, if any, distributed. A personal representative will not want to make distribution until the taxes and debts are paid. Presumably, a trustee would be equally cautious.

Assets "subject to probate" do not include jointly held accounts, accounts for which a beneficiary, other than the estate, is named, and real estate outside Virginia. Quite often, the bulk of an individual's assets is held in this form and is already “avoiding” probate.

1. **The cost of probate.** Brochures promoting living trusts usually estimate the cost of probate at 3-10 percent of the estate's gross value, before debts are paid. This estimate is said to cover court costs, and legal and executor fees, which, by implication, are avoided by using a trust.

Court costs. In Virginia, the court costs would include the clerk's fees, probate taxes, and the fees paid to the Commissioner of Accounts. The clerk's fee for recording a will is $13.00 for the first four pages, and $1 for each additional page.26 The clerk's fee to qualify the personal representative is $25 - $30. The probate tax is one-tenth of one percent of value of probate estate.27

The Commissioner of Accounts fees include the cost to file and Inventory ($63 to $163); and the cost to file annual accounts (First Account - $113 to $10,013; subsequent accounts limited to maximum of one-half of fee paid to file the First Account, but not less than $100). Annual accounts for testamentary trusts can be waived, but if they are not, the fees are similar to the fees for estate accountings. In addition, a simple statement in lieu of an account (filing fee $88) may be filed if all of the residuary beneficiaries are also serving as the personal representatives.28

These costs, while generally not excessive in relation to the size of the estate, can be avoided, in whole or in part, to the extent that assets are titled in the name of a living trust at the time of the grantor's death. To the extent that a living trust is not funded during lifetime, these costs are not avoided.

Legal and accounting fees. Much is made of the fees charged by lawyers in the probate process. One brochure states that there will be no legal fees with a trust. In reality, if legal or accounting advice is necessary for administration of the probate estate, legal or accounting assistance will be needed for the administration of the trust. Legal or accounting assistance is most often needed in large estates, especially where an estate tax and fiduciary income tax returns must be prepared and filed. The filing requirements, and the resulting fees, are the same whether a will or a living trust is used.

**Commission for the personal representative.** While commissions are not mandatory in Virginia, a personal representative is entitled to payment for his service. A fiduciary whose accounts are settled before the Commissioner of Accounts is entitled to "reasonable" compensation.29 While there is no statutory provision applicable to living trusts, a family member or friend who serves as trustee is as likely to take, or decline to take, a commission,
as he would if serving as personal representative. A professional fiduciary is going to charge for its services, whether the service is rendered as a personal representative or a trustee. In certain situations it makes sense for a beneficiary who is also a fiduciary to take the greatest commission possible because the estate can deduct the commission at the federal estate tax rate (37%-55%), while the personal representative pays taxes on the commission at his or her personal income tax rate (15% - 39.6%).

2. The delay caused by probate. In perhaps one of their most outrageous claims, some living trust promoters assert that it will take months or "even years" for the beneficiaries of a will to receive their inheritance, while the beneficiaries of a trust of similar size would receive their inheritance within four to eight weeks. An exception is sometimes made for larger estates where distribution would depend "primarily upon estate tax filing requirements."

In Virginia, the personal representative can qualify as soon as a death certificate is available and could begin to distribute assets immediately thereafter, however imprudent that might be. Assets are not "frozen." In Virginia, real estate "drops like a rock" to the beneficiary upon probate of the will. A deed is not needed to convey ownership. If the living trust is to own the land, a deed is necessary to convey the property to the trust, and a second deed is necessary to convey the property to the beneficiary after death.

As noted above, a personal representative can obtain the protection of an Order of Distribution within six months and make complete distribution by that time. A trustee cannot secure that protection and might deem it prudent to wait longer than six months to make final distribution.

In reality, the time and cost to complete administration of a will or a trust will depend upon the size of the estate and the nature of the assets. In many estates, the most important variable to determine the time and cost expended before complete distribution will be the nature of the beneficiaries. Not surprisingly, family members bring the largest number of will contests against each other. The use of a living trust is not likely to change that dynamic.

3. A living trust can avoid probate in more than one jurisdiction. If a grantor owns real estate in more than one state, depending upon the probate rules of each jurisdiction, transferring the property to the trust before death may simplify the administration process. However, before the foreign real estate is transferred to a living trust, that state's laws covering transfer taxes and recordation fees; inheritance taxes; homestead limitations (does transfer of the property to the living trust cause the property to lose its homestead exemption?); and zoning rules (will transfer of the property to a living trust result in the loss of "grandfathering" where very restrictive zoning laws have been enacted?) should be carefully examined.

A Living Trust Ensures Privacy for Your Family. Wills are recorded in the land records. The inventory and accounting are generally also matters of public record. An inter vivos trust is typically not recorded. For individuals concerned about keeping their dispositive plans or assets private, this can be an important distinction.

A living trust does not guarantee privacy. To open an account for the trust many banks and brokerage firms require a copy of the agreement. In Maryland, a schedule of trust assets must be filed with the Register of Wills and becomes a public record. In D.C., the Register of Wills might require the filing of a copy of the trust agreement.

Under Virginia law, a trustee has a duty to disclose information to the trust beneficiary that is reasonably necessary to enable the trust beneficiary to enforce his rights under the trust or to prevent or redress a breach of trust. A trust beneficiary is entitled to review the entire trust agreement even if he is the beneficiary of only one of two separate trusts created under the
trust agreement and he has received all the pages relevant to his trust.\textsuperscript{33}

While a copy of a trust may be harder to obtain than a copy of the will, an interested party, in all likelihood, will be able to obtain a copy of the trust and an accounting of its assets. When a client emphasizes his desire for privacy, it might be wise to determine why. Is he worried about the nosy next door neighbor? Business competitors? Or is he concerned about family members who are already fighting over his money before he is dead? Proponents of living trusts claim that because the will is a public document it may invite unhappy heirs to contest the will. Yet, if the family has a history of fighting, or has long been suspicious of each other, efforts to ensure privacy and avoid probate may lead to increased disputes among the heirs and between the heirs and fiduciaries. Court supervision might be advantageous in such a family.

\textit{A Living Trust is Harder to Contest Successfully Than a Will, So Your Wishes are More Apt to be Followed.}\textsuperscript{34} The preliminary question for a client who is concerned about a contest of his will, is the source of this concern and the basis upon which he feels a contest may be asserted. As with the client who is concerned about privacy, the use of a trust to avoid a contest, may invite suspicion and a contest. Living trusts are not immune from attack.

The Virginia Code sets forth the procedures by which an interested party may seek to impeach or establish a will, including the right to a jury trial.\textsuperscript{35} An action to impeach a will must be brought within six to twelve months of probate. While these sections do not apply to trusts, a disgruntled family member could file a declaratory judgment seeking to have the trust declared invalid or set aside.\textsuperscript{36}

Because a living trust is not considered testamentary and does not require the formalities of a will to be effective, one ground on which a living trust is immune from attack is failure to follow testamentary formalities.\textsuperscript{37}

Oral trusts are permitted with respect to both personal property and real property in Virginia.

Many lawsuits over wills do not directly involve competing beneficiaries. A suit may be brought by a personal representative or a trustee because of an ambiguity in the provision of the will or trust agreement or uncertainty in the administration of the trust.\textsuperscript{38} A beneficiary may file suit against a drafting attorney on the basis of breach of contract if the disappointed beneficiary believes he was an intended beneficiary of the will or trust agreement and because of the drafting attorney’s error, he did not receive the benefit intended for him.\textsuperscript{39} A living trust does not minimize the likelihood of either type of action.

1. \textit{A living trust can be attacked on the basis of the grantor’s lack of capacity}. Any person who has legal capacity may make a valid will. Generally the standard of capacity is: does the person know the natural objects of his bounty, the nature of his property, and does he know how he wishes to dispose of his property.\textsuperscript{40}

The “vast majority” of courts who have ruled have found that it takes less “mental capacity” to make a will than it does to make a simple contract.\textsuperscript{41} Maryland is one of only four states that have found that the capacity to make a will and to make a contract involve identical legal principles.\textsuperscript{42}

Virginia does not appear to have a case discussing the capacity required to make a will as compared to the capacity to create a living trust. Virginia's standard to create a will is relatively simple. Indeed, the Virginia Supreme Court has held that a pending competency hearing or subsequent determination of incompetency does not establish whether testamentary capacity exists at the time the will was executed.\textsuperscript{43} The appointment of a guardian is not \textit{prima facie} evidence of mental incapacity.\textsuperscript{44}

Clients, even with limited capacity, generally understand what a will is and what it
does. A trust is a much harder concept to explain. Depending upon the client, it might actually be easier to contest a trust than a will on the grounds of lack of capacity.

2. A living trust can be attacked on the basis of undue influence. Virginia has extensive case law on setting aside a will based on undue influence. A presumption of undue influence may arise where the contestant proves by clear and convincing evidence that: the testator was enfeebled in mind when the will was executed; the requisite confidential or fiduciary relationship was accompanied by activity in procuring or preparing the favorable will; and, the testator previously had expressed a contrary intention to dispose of his property. The must be a confidential or fiduciary relationship and the relationship must be accompanied by activity on the part of the dominant person in procuring or preparing the will in his favor.

Undue influence is a "species of fraud." The equity principals of fraud and duress would be available to contest the provisions of a trust.

3. The Commissioner of Accounts system may help prevent litigation. Sometimes dismissed as an unnecessary expense, the accounting requirement forces the personal representative to disclose the estate’s assets and their disposition on a regular basis. The Commissioner of Accounts office can then provide an informal forum for resolution of disputes that may arise between the fiduciary and the beneficiaries or creditors.

Fiduciaries have been known to help themselves to the assets under their control. The disclosure required in the annual accounts may provide an early alert to the improper disposition of assets. The trustee is ultimately accountable to the beneficiaries, but without a regular reporting requirement, a trustee may have greater opportunity to benefit himself at the expense of the beneficiaries. The breach of fiduciary duty might not be discovered until it is too late to recover the missing assets. Once discovered, the beneficiaries could not turn to the commissioner for assistance in accounting for or collecting the missing assets, but would have to retain legal counsel and pursue their claim in court.

A Living Trust Avoids Probate Upon Incapacity. Proponents of living trusts assert that without a living trust, if you become incapacitated a court will appoint a conservator to run your estate as the court sees fit. Your family would have to go through probate twice!

In Virginia, if an incapacitated individual does not have a power of attorney or a living trust, the court, upon the petition of an interested party, may appoint a conservator. The conservator is bonded and is required to report annually to the Commissioner of Accounts. These requirements may be attacked as the court having jurisdiction over the estate sees fit, but in many respects, as unpleasant a process as it is, a conservatorship provides greater protection for the incapacitated individual than a living trust or power of attorney.

A living trust provides for management of assets upon disability. A living trust can be a useful tool if a person is in poor health, or does not want to manage his affairs. Yet, a power of attorney can often work just as well.

One of the most difficult aspects of drafting a living trust is the language used to "trigger" the authority of the successor trustee to act once the grantor becomes incapacitated. Few grantors are willing to cede title and control to their property to a third party until absolutely necessary. To the extent that an individual is willing to create a power of attorney that is immediately effective, with the expectation that the individual named will not act until necessary, a power of attorney may be a better option than a living trust.

A power of attorney is generally less expensive and complicated to create than a trust. Many banks and brokerage firms have their own forms that can be executed without the assistance of an attorney. As with a will, clients more readily grasp the concept of a power of attorney than a living trust.
Virginia law requires an agent under a power of attorney, upon a “reasonable written request made by a person interested in the welfare of a principal who is unable to attend to his affairs” to account for his actions taken within two years prior to the date of the request or the death of the principal. An agent who refuses to comply can be held liable for the expenses and attorneys' fees of the requesting party. A “person interested in the welfare of the principal” is defined as any member of the principal's family; a person who is a co-agent, alternate agent or successor agent under the power of attorney; and if none of those persons is reasonably available, the adult protective services unit of the social services board. A member of the family is defined as an adult parent, brother or sister, niece or nephew, child or other descendant, spouse of a child of the principal, spouse or surviving spouse of the principal.

While the common law requires a trustee to account to the beneficiaries of the trust, there is no clear statutory procedure to follow or statutory right to assess attorney's fees if the trustee is not forthcoming. In addition, the class of beneficiaries who have the right to an accounting will usually be much smaller than the class of individuals deemed to be "a person interested in the welfare of the principal". It may be easier and less expensive for a family member to protect an incapacitated person under a power of attorney than a living trust.

As a final consideration, Virginia law protects the beneficiary whose bequest is sold by an attorney in fact. Absent a contrary provision in the will or power of attorney, a bequest or devise of specific property shall be deemed to be a legacy of a pecuniary amount if the specific property is sold during the lifetime of the testator while he is incapacitated. This protection is not provided if a trustee should sell or otherwise dispose of an asset held in trust.

Caveat — Differences in the rules of construction. Many “common-law” rules that have evolved in the construction of wills do not apply to living trusts, sometimes with unexpected results. Many of these problems can be avoided by careful drafting of the trust but practitioners need to be aware of the differences. For example, divorce or annulment of the marriage revokes any dispositions in favor of the spouse under the will, as well as any fiduciary nomination of the spouse. Divorce revokes any revocable beneficiary designation for a former spouse. These provisions specifically do not apply “to any trust or any death benefit payable to or under any trust.”

A bequest of securities includes additional securities owned by the testator at death resulting from stock splits, mergers or reorganizations. A bequest or devise of property applies to unpaid condemnation awards or unpaid proceeds from fire or casualty insurance. This statute does not apply to distributions from revocable trusts.

Absent a contrary intention expressed in the will, bequests or devises to persons related to the testator who fail to survive the testator pass instead to surviving descendants of the deceased person. The anti-lapse statute does not apply to trusts.

The “Slayer” Statutes provide that a convicted murderer (or fugitive) of the testator who receives a bequest or devise under the will is deemed to have predeceased the testator. The murderer does not take a survivorship interest in joint or tenants by the entirety property. Insurance proceeds are not to be paid to the murderer. Property passing pursuant to a revocable trust is not explicitly addressed. Presumably this is not a major issue in most estates but would be an awkward subject to address in drafting.

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The differences between a will and a living trust are more complex, and less one-sided, than the tireless promoters of living trusts acknowledge. A living trust is advantageous for a person who is ready to turn over management of his assets to a third party. A living trust may
minimize the costs of probate in circumstances where the person owns real estate in several states. A living trust may help ensure privacy in cases where the grantor wishes to shield his planning from the public at large, not necessarily his family in particular.

To obtain the perceived benefits of a living trust, an individual must transfer title to his assets to the living trust during his lifetime. How many clients, especially younger ones, will be willing to do that? And how many will continue to maintain that titling as the nature and composition of their assets change over time?

Neither the probate system nor, as a general rule, lawyers, cause families to contest the wishes of an individual as expressed in his will. A living trust will not change human nature or make a dysfunctional family behave. Some of our clients who are worried about privacy and family fighting might be better served by the "public" nature of probate, with its required accountings and the oversight of the Commissioner of Accounts.

The probate system, for all its perceived faults, includes many benefits and protections that perhaps we take for granted. Only time will tell if living trusts eliminate the need for those protections that now stand accused of causing needless cost and delay.

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**ENDNOTES**

1 The term “living trust” as used here means a trust established during the lifetime of a grantor, in which he retains the right to income and principal and the right to amend or revoke the trust at any time prior to death.
2 The author was consulted by an individual who wanted to sue her husband’s attorney for malpractice for preparing a will rather than a revocable trust.
3 The living trust is revocable. The individual has generally retained the right to the income and principal of the trust. Accordingly, the trust income is taxable to the grantor and the assets are included in his estate at death. I.R.C. §§ 2036, 2038.
4 I.R.C. § 1361(b)(1)(b).
5 I.R.C. § 1361(c)(2)(A).
9 The augmented estate includes any assets under which the decedent retained for his life the possession or enjoyment of or right of the principal for his own benefit, or over which he retained a power of revocation. Va. Code. § 64.1–16.1
12 See generally, Scott on Trusts, § 330.12, n.8.
13 Id. at § 505(a)(3).
15 Va. Code § 64.1-151.2.
16 Va. Code § 64.1-151.3.
20 Id.
21 Id.
23 Va. Code §§ 64.1-57 - 64.1-159.
24 RESTATEMENT (SECOND) OF TRUSTS § 187 (1959) [hereinafter RESTATEMENT]; NationsBank v. Grandy, 248 Va. 557, 415 S.E.2d 140 (1994) (“a trustee’s exercise of discretion shall not be overruled by a court unless the trustee has clearly abused his discretion or acted arbitrarily”).
25 A trustee must exercise due care, diligence and skill in the administration of the trust or face personal liability for the resulting losses. RESTATEMENT at §§ 170-174.
30 Ross and Reid, WILL CONTESTS at § 7 (2d ed. 1999).
31 Va. Code § 64.1-94.
33 Id.
36 See Va Code § 8.01-184, et seq.
37 See Va. Code §§ 64.1-46, -47 and -49 (setting forth the statutory formalities for the execution of a will or the probate of a holographic will); Bickers v. Shenandoah National Bank, 197 Va. 145, 88 S.E.2d 889 (1955); reh’q denied, 197 Va. 732, 90 S.E.2d 865 (1956) (a revocable inter vivos trust is not considered testamentary and does not require the formalities of a will to be effective).
38 B. Lamb, VIRGINIA PROBATE PRACTICE, 238 (1957) (“A fiduciary is not required to act at his peril; he need not eat the doubtful vegetable to ascertain if it is a wholesome mushroom or a poisonous toadstool as poor Alice was advised to do.”).
39 Copenhagen v. Rogers, 238 Va. 361, 384 S.E.2d 593 (1989); see generally Armstrong & Pomeroy, supra note 34.
41 Ross and Reed, supra note 30, § 6:5.
42 Id. note 53, (citing Doyle v. Rody, 180 Md. 471, 25 A.2d 457 (1942)).
44 Gibbs, (citing Gilmer v. Brown, 186 Va 630, 464, 44 S.E. 2d 16, 21 (1947)).
47 Jarvis v. Tonkin 380 S.E.2d 900.
49 Va. Code § 37.1-134.22.B.
50 Va. Code § 37.1-134.22.C.
51 Va. Code § 64.1-62.3.
55 Va. Code § 64.1-62.3.
56 Va. Code § 64.1-64.1.
Quantifying the Discount for Lack of Marketability Due to Imbedded Capital Gains

Deducting Built-In Capital Gains Tax

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This article discusses the background and increase in the discount for lack of marketability due to built-in capital gains taxes. In the following we will answer three basic questions:

- Do we deduct for built-in capital gains taxes when valuing a Post-1986 C-Corporation?
- Where do we deduct the taxes?
- How much of the tax is deducted?

The Nature of Built-In Capital Gains

Subsequent to the repeal of the General Utilities doctrine in 1986, C-Corporations that liquidate must now pay capital gains taxes at the corporate level as well as at the shareholder level on any additional gains they may have. This corporate level tax is what we will refer to in this section as the “built-in capital gains tax.”

Deducting Built-In Capital Gains Tax

In deciding whether to adjust for built-in capital gains tax we can approach the question from two perspectives – the hypothetical willing buyer’s and seller’s, and the courts’ perspective. We will start with the hypothetical willing buyer and seller.

The bedrock of valuation theory rests in the definition of fair market value, the standard of value used in estate valuations, as follows:

...the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical willing buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market.


The argument for making an adjustment for built-in capital gains tax is based on what a willing buyer would pay for any particular investment. Assuming that valuation theory considers any theoretical buyer, one must assume that, based on rational thinking:

- Any buy decision is made to have the highest economic results inure to the buyer.
- Under the economic principles of anticipation and substitution, a willing buyer would want to pay a lower price to acquire an interest in a real estate holding company organized as a C-Corporation with a built-in capital gains tax liability than for the same interest in an identical entity that was organized differently.
- If the taxes imbedded in a transaction (property) cannot reasonably be expected to be avoided, a willing buyer would assess the potential cost and take this into account by lowering his offer.
Any willing seller (within the context of fair market value) would be expected to have taxes taken into account.

When we looked at the business valuation literature, we found several relevant articles:

Shannon Pratt, FASA, CFP, DBA, known as the most widely respected business appraiser of our times, in the February 2, 1996 issue of his Business Valuation Update stated:

In most (if not all) cases, I believe that the liability for trapped-in gains taxes should be reflected in the value of the stock or partnership that owns the assets.

Consensus is building among appraisers that the built-in capital gains tax should be recognized one way or another, either in the form of a balance sheet adjustment or some type of discount.

In the June 1999 issue of Business Valuation Review, David M. Bishop, ASA, FIBA, BVAL, MCBA argued that it was time for business valuation experts to explore more the considerations of built-in capital gains taxes when they were relevant. Even though this article was written subsequent to the Davis and Eisenberg Tax Court cases discussed below, he argued:

the pure marketplace view seems to be that the hypothetical buyer acting without compulsion under the fair market standard would have the alternative of selecting other comparable property with the same or very similar market value which does not have imbedded gains. This is consistent with the underlined portion of the Circuit Court’s position in Eisenberg.

In his treatise “Imbedded Capital Gains in Post-1986 C-Corporation Asset Holding Companies,” published in the November/December, 1998 issue of Valuation Strategies, the likewise acclaimed founder of Mercer Capital, Z. Chris Mercer, ASA, CFA argued for taking adjustments in appraisals to reflect built-in capital gains taxes. His article included 5 examples (scenarios) dealing with such taxes. His conclusions were:

Overall Conclusion

A rational willing buyer will pay no more than a price for shares of a C corporation asset holding entity that recognizes 100% of the imbedded gain tax liability in that C corporation. A rational seller will sell for no less than this amount because of the ability to liquidate and achieve this result. Rational negotiations between hypothetical willing buyers and sellers should lead to a full recognition of imbedded capital gains tax liabilities in the determination of the price to be paid for the C corporation’s share (absent any compulsion on the part of the buyer or the seller).

Our Position Based on Hypothetical Buyers and Sellers

After studying the literature and using common sense regarding the definition of fair market value, we concluded that an adjustment for imbedded capital gains taxes should be taken into account when valuing a C-Corporation. Additionally there is nothing indicating that a hypothetical willing buyer would take less than the full amount of the taxes into account on a present value weighted basis in buying the asset.

The Courts

The courts recently have issued two landmark cases regarding the recognition of a discount for trapped in capital gains taxes, Estate of Davis v. Commissioner, and Eisenberg v. Commissioner. Both support the call for an increase in the discount for lack of marketability when a C-Corporation holding assets with built-in capital gains is valued.

Estate of Davis v. Commissioner, 10 T.C. 35 (1998)

This case involved the estate of Artemis D. Davis who made two gifts of ADDI&C, Inc. stock in 1992, both gifts reflecting a 15 point
increase to the discount for lack of marketability due to the built-in capital gains taxes. In the final outcome the court sided (for the most part) with the estate's expert, Dr. Shannon Pratt. The court *did not* however allow the full amount of the taxes to be deducted. It indicated that the full reduction of the taxes would be allowed only if there was a planned liquidation.

The court stated:

Although Dr. Pratt recognized in his expert report that as of the valuation date it would have been possible for ADDI&C to convert to an S corporation, he did not consider conversion to S corporation status to be likely...such an assumption would have impermissibly limited the hypothetical willing buyer of each of the two blocks of stock at issue to certain individuals and entities who were permitted as of the valuation date to be shareholders of an S corporation, see sec. 136(b)(1)(B) and (C), thereby improperly excluding as a hypothetical willing buyer of each such block, for example, a C corporation...

...we agree that as of the valuation date it was unlikely that ADDI&C would have converted to an S corporation. Based on the record before us, we reject respondent’s unwarranted assumptions that ADDI&C could have avoided all of ADDI&C’s built-in capital gains tax by having it elect S corporation status and by not permitting it to sell any of its assets for 10 years thereafter, and the record does not establish that there was any other way as of the valuation date by which ADDI&C could have avoided all of such tax.

We are convinced on the record in this case, and we find, that, even though no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of ADDI&C’s built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of ADDI&C stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no ADDI&C’s built-in capital gains taxes of that date.

*Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998)

This case involved gifts made by Irene Eisenberg for taxable years 1991, 1992, and 1993 for which the IRS determined deficiencies of $20,158, $38,257, and $3,320 respectively. The Tax Court found that a discount for built-in capital gains taxes does apply. Ms. Eisenberg appealed the case to the United States Court of Appeals for the Second Circuit, and a decision was handed down on August 18, 1998.

In its decision, the court remanded the case to the Tax Court to determine the gift tax liability consistent with the opinion. The opinion reflected:

In the past, the denial of reduction for potential capital gains tax liability was based, in part, on the possibility that the taxes could be avoided by liquidating the corporation....

These tax-favorable options ended with the enactment of the Tax Reform act of 1986....

Many courts also base their decision (prior to TRA 86 not allowing the deduction for built-in capital gain) on the ability of the corporation to avoid
corporate taxes altogether (upon liquidation).

Courts may not permit the positing of transactions which are unlikely and plainly contrary to the interest of a willing buyer.... We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property.

We disagree with the Commissioner’s reasoning that the critical point in this case is that there was no indication a liquidation was imminent or that a “hypothetical willing buyer would desire to purchase the stock with the view toward liquidating the corporation or selling the assets, such that the potential tax liability would be of material and significant concern.” Eisenberg v. Commissioner, 74 T.C.M. (CCH) 1046, 1048-49 (1997). The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the TRA any buyer of a corporation’s stock would avoid potential built-in capital gains tax, there is simply no evidence to dispute the fact that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of the buyer’s inability to eliminate the contingent tax liability.

We are convinced on the record in this case, and we find, that, even though no liquidation of [the corporation] or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of [the corporation’s] built-in capital gains tax. We are also persuaded on that record, and we find, that such a willing seller and such a willing buyer of each of the two blocks of [the corporation’s] stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands that was less than the price that they would have agreed upon if there had been no...built-in capital gains tax as of that date.... We have found nothing in the...cases on which respondent relies that requires us, as a matter of law, to alter our view....

We were advised that on remand, Eisenberg was settled at a discount for trapped in gain approximately equal to the percentage in Davis which was 13.2% applied to the net asset value of $80.14 million after a reduction of 15% for a minority interest discount and a 27.9% marketability discount. In Eisenberg, the dollar amount $9 million represents 36% of the estimated tax of $25.4 million due to the imbedded capital gain or 11.2% of the net asset value of the stock.

**Our Position Based on Economic Rationality and the Perspective of the Courts**

Based on both sound economic theory and the relevant court cases, we conclude that it is appropriate to adjust our valuation to fully reflect the built-in capital gains taxes on a present value weighted basis.

**Where to Deduct Taxes**

We agree with courts (Davis and Eisenberg) that the deduction for built-in capital gains taxes should be reflected as an adjustment to the discount for lack of marketability. We feel that the portion of the discount for lack of marketability due to built-in capital gains is an issue for both control and minority stockholders, accordingly it would be
inappropriate to reflect the liability to the net asset value of an asset which by definition is a control value.

By placing the adjustment in the discount for lack of marketability it rests purely with marketability and not with percentage of control.

**How Much to Deduct**

The amount (%) of built-in capital gains to be reflected as an increment to the discount for lack of marketability continues to be argued. The IRS would like it to be zero unless a sale is imminent. Others like Shannon Pratt have settled for an amount equal to 15% of the minority marketable value. The courts indicate 11%-13% of net asset value. When interviewed by D. B. Gray, CPA/ABV, MBA, CBA, ASA of SE Biz Val, LLC, Dr. Pratt indicated that his finding in Davis represents more of a gut feel of what the IRS would accept than any pure economic model. We feel there are 2 models that should be considered in determining how much of the total built-in capital gains tax should be included in the discount for lack of marketability. First, a 50/50 split of the tax liability between buyer and seller, or second, recognize 100% of the tax liability on a present value weighted basis as a reflection in the discount for lack of marketability.

**50/50 Split**

Some would argue that the hypothetical willing buyer and seller would “split the baby” and agree to ½ of built-in capital gains taxes to reduce the selling price. The buyer would pay more, and the seller get less, but at least each would accomplish their objective.

We would reject this notion because under the theory of fair market value, the buyer can buy any asset of equal risk in any ownership form he wishes, and would not buy an asset whose entity form causes it to be less valuable.

**Recognize 100% of the Tax**

By definition, fair market value implies that a *sale* will take place. Since neither the buyer nor the seller is compelled to deal with each other, we must assume that they will deal with the facts and circumstances in a prudent manner. Assuming there are many investment opportunities to the buyer, there is no reason why the seller of a C-Corporation with built-in capital gain could expect the buyer to share in that liability. Hence, we would conclude that by definition, the seller would be expected to absorb all of the built-in capital gains taxes.

**Our Position**

Based on the definition of fair market value, we conclude that the SELLER would expect *and accept* that the *full* amount of built-in capital gains taxes on the sale of his C-Corporation stock would be reflected in the price to be paid for the stock. We do not feel however, that the taxes should be directly subtracted from the net asset value, but rather determined after the adjustment for lack of marketability for reasons other than taxes. In addition, we realize that the built-in capital gain tax liability may not be payable at once, but is contingent upon the timing of the liquidation of the corporation’s assets. Hence, there is a “time value of money” factor that would be rationally considered by both a knowledgeable seller and a knowledgeable buyer of the subject interest in the Company.

The remainder of this article addresses the magnitude of the appropriate discount for lack of marketability attributable to the built-in capital gains tax liability through LEC, a hypothetical real estate holding company. We will first consider the built-in gains tax as if LEC were to liquidate all of its real estate immediately. We will then assess the value of the built-in tax liability by taking the present value of those taxes over a more reasonable period of liquidation. Subsequently we will measure the potential total cash returns to LEC assuming on-going earnings, capital appreciation and liquidation over a period of ten years, the difference in present value compared to net asset value being the total marketability discount. Finally we will review the reasonability of our conclusions compared to certain market measures.
Value of the Marketability Discount for Taxes if LEC Liquidated Immediately

We begin our analysis by assessing the full value of the built-in capital gains tax liability as if all of LEC’s real estate portfolio was to be liquidated as of the valuation date. The table below provides those calculations:

<table>
<thead>
<tr>
<th>Net Realizable Value to Equity Upon Total Liquidation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Net Asset Value</strong></td>
</tr>
<tr>
<td>Marketability Discount @ 27.5%</td>
</tr>
<tr>
<td><strong>Net Realizable Value of Upon Liquidation</strong></td>
</tr>
<tr>
<td>Built-in Cap Gains Tax @ 38% rate $139,000 basis</td>
</tr>
<tr>
<td><strong>Net Realizable Value to Shareholders</strong></td>
</tr>
<tr>
<td>Interest Being Valued = 63%</td>
</tr>
<tr>
<td><strong>$ Amount</strong></td>
</tr>
<tr>
<td>2,027,044</td>
</tr>
<tr>
<td>(557,437)</td>
</tr>
<tr>
<td>1,469,607</td>
</tr>
<tr>
<td>(505,631)</td>
</tr>
<tr>
<td>963,976</td>
</tr>
<tr>
<td><strong>$606,605</strong></td>
</tr>
<tr>
<td><strong>% Beg NAV</strong></td>
</tr>
<tr>
<td>100.0%</td>
</tr>
<tr>
<td>-27.5%</td>
</tr>
<tr>
<td>72.5%</td>
</tr>
<tr>
<td>-24.9%</td>
</tr>
<tr>
<td>47.6%</td>
</tr>
<tr>
<td>29.9%</td>
</tr>
</tbody>
</table>

Fair Market Value of 63% Interest in LEC ( Rounded ) $610,000

Hence, we observe above that if LEC were to recognize all of the built-in capital gains tax liability as of the date of liquidation, the total amount would be $505,631 or 24.9% of net asset value. We calculate this tax after taking into consideration a 27.5% discount for lack of marketability due to factors other than taxes.

We consider the approximate $500,000 built-in gains tax liability assessed here to be the upper limit of what a willing buyer/seller would negotiate. In this example we assume the following:

LEC would be unable to sell its real estate portfolio in less than six years without unduly depressing the local real estate market;

(1) A reasonable buyer of the 63% restricted control interest in LEC might choose to liquidate the real estate portfolio over a longer period of time, either reinvesting in higher returning assets or distributing the proceeds to shareholders (with other shareholder approval); and

(2) Based upon a reasonable liquidation time horizon, a rational investor would view the potential $500,000 built-in capital gains tax liability as being worth something less due to the “time value of money.”

Hence, under this method we might set an upper limit as to what the built-in gains tax liability might be worth. Our conclusion of fair market value for the subject interest under appraisal is $610,000, which we view as the lower limit of its value. Under the next two methods, we explicitly address the “time value of money” issue in regards to this important component of the marketability discount.

Value of the Marketability Discount for Taxes if LEC Liquidated Over 6 Years

We feel the discount for lack of marketability is a function of how long it would take to find a buyer who wanted to buy 54 pieces of property and the most likely discount the buyer would require. From that we develop our discount for lack of marketability due to taxes on imbedded capital gains.

Time to Sell

Due to the nature of the assets, we are concerned with how long it would take a buyer
to buy, fix up and market the assets within LEC. This time is similar to the calculation considered in blockage discounts. However, since blockage discounts generally apply to large blocks of listed stocks, we do not feel it appropriate to develop our discount strictly along that model.

We interview several real estate professionals to estimate the length of time for a buyer to “get his money out” of LEC. The owner feels it would take 5-10 years to liquidate LEC without saturating the market. Mr. Appraiser appraised the net asset value of each parcel of real estate on a STAND-ALONE basis and did not adjust for saturation of the market. He felt that the time frame for any piece of real estate to sell would be 2 years.

We also discuss selling LEC’s assets with a realtor with prior experience with LEC assets who currently has several properties listed. Her estimate is that about 25% of the real estate could be sold in the first year, and then 15% per year thereafter over the next 5 years. We use this estimate in our calculation.

To develop our discount rate, we determine that in cases in which the income approach was used, the weighted average discount rate of 10.85% was used to indicate value. Thus, we are persuaded that this is a reasonable required rate of return or “discount rate” with which we calculate our assessment of the “present value weighted” built-in capital gains tax liability.

**Tax Rates/Basis**

The basis of the properties in LEC is $139,000. We assume that since LEC has had few profits in the past the only taxable income the company would have would be from property sales and we determined the estimated tax to be paid on that income. We assume that basis would be allocated pro rata 139,000/1,831,850 or 7.6% of the sale price.

By adjusting the results for time we determine that the most taxes LEC would pay in present dollars would be $319,849 as shown in the schedule on the opposite page.

**Conclusion**

Based on this valuation methodology, we therefore conclude that the value of a 63% non-marketable equity interest in LEC is $720,000, calculated as follows:

- 100% Non-Marketable Value: 1,149,758
- 63% Ownership Interest: 723,512

**Rounded:** $720,000

**Value of Average Discount if LEC Liquidated Each of Next 10 Years**

Another perspective to review is to answer the question “What would a reasonable investor expect to realize in actual cash returns on his investment in a 63% restricted control interest in LEC?”

We attempt to answer this question by analyzing the net realizable cash available to LEC upon liquidation for each of the next ten years. We then take the present value of each of those liquidation scenarios and finally average them together to assess what the average expected present value would be for those net cash returns.

The average net present value of these liquidation proceeds would therefore equal the fair market value of 100% of LEC. The difference between this fair market value and LEC’s net asset value would constitute the total discount for lack of marketability.

**Fundamental Liquidation Assumptions**

If we assume that in each of the following 10 years, LEC liquidates its total portfolio and distributes the proceeds to shareholders, we need to make some basic assumptions regarding retained earnings, capital appreciation, tax rates, built-in gains tax rate, basis of the built-in gain tax liability, marketability discount due to other than tax issues, and what the appropriate discount rate should be. The schedule on page 26 presents these assumptions.
**LEC**

**Quantifying the Capital Gains Discount**

<table>
<thead>
<tr>
<th>Notes</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent Sold</td>
<td>25%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>100%</td>
</tr>
<tr>
<td>Dollar Amount Sold</td>
<td>457,963</td>
<td>274,778</td>
<td>274,778</td>
<td>274,778</td>
<td>274,778</td>
<td>274,778</td>
<td>1,831,850</td>
</tr>
<tr>
<td>1Marketable Discount</td>
<td>(125,940)</td>
<td>(75,564)</td>
<td>(75,564)</td>
<td>(75,564)</td>
<td>(75,564)</td>
<td>(75,564)</td>
<td>(503,759)</td>
</tr>
<tr>
<td>Estimated Sales Price</td>
<td>332,023</td>
<td>199,214</td>
<td>199,214</td>
<td>199,214</td>
<td>199,214</td>
<td>199,214</td>
<td>1,328,091</td>
</tr>
<tr>
<td>2Estimated Basis</td>
<td>34,750</td>
<td>20,850</td>
<td>20,850</td>
<td>20,850</td>
<td>20,850</td>
<td>20,850</td>
<td>139,000</td>
</tr>
<tr>
<td>Estimated Gain</td>
<td>297,273</td>
<td>178,364</td>
<td>178,364</td>
<td>178,364</td>
<td>178,364</td>
<td>178,364</td>
<td>1,189,091</td>
</tr>
<tr>
<td>3Estimated Tax</td>
<td>115,461</td>
<td>61,964</td>
<td>61,964</td>
<td>61,964</td>
<td>61,964</td>
<td>61,964</td>
<td>425,278</td>
</tr>
</tbody>
</table>

| Capital Gains Tax Rate                  | 38.8% | 34.7% | 34.7% | 34.7% | 34.7% | 34.7% | 35.8% |
| When Asset Sales Occur                  | 1.25  | 1.50  | 2.50  | 3.50  | 4.50  | 5.50  |
| 4Discount Rate @ 10.85%                 | 0.88  | 0.86  | 0.77  | 0.70  | 0.63  | 0.57  |
| Present Value of Taxes                  | 101,511 | 53,092 | 47,896 | 43,208 | 38,979 | 35,163 |
| Total Present Value of Taxes            | 101,511 | 53,092 | 47,896 | 43,208 | 38,979 | 35,163 |

**Tax Due to Capital Gains** = **319,849**

| Net Asset Value of LEC                  | 2,027,044 |
| Capital Gains Discount                 | 15.8%     |

| Net Asset Value                        | 2,027,044 | 100.0% |
| Discounts for Lack of Marketability    |           |
| Due to reasons other than taxes        | 557,437   | 27.5%  |
| Net                                   | 1,469,607 |
| Due to taxes                          | 319,849   | 21.8%  |
| Non-Marketable Value                   | 1,149,758 |

| Combined Discount                     | 43.3%     |

---

1 Initial Discount for Lack of Marketability @ 27.5%
2 7.6% of NAV or Percent Sold x 139,000
3 Federal at actual rate, Virginia at 6%
4 Assumed first year taxes due *after* first year, but then evenly distributed throughout the remaining years.
ASSUMPTIONS

Composition of Investments & Estimated Returns on Net Asset Value ("NAV")

<table>
<thead>
<tr>
<th>Real Estate</th>
<th>1,831,850</th>
<th>7.00%</th>
<th>4.00%</th>
<th>11.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Securities</td>
<td>195,721</td>
<td>4.00%</td>
<td>7.00%</td>
<td>11.00%</td>
</tr>
<tr>
<td>+ Cash</td>
<td>4,480</td>
<td>1.00%</td>
<td>0.00%</td>
<td>1.00%</td>
</tr>
<tr>
<td>- Liabilities</td>
<td>(5,007)</td>
<td>9.00%</td>
<td>0.00%</td>
<td>9.00%</td>
</tr>
<tr>
<td>NAV</td>
<td>2,027,044</td>
<td>6.69%</td>
<td>4.29%</td>
<td>10.98%</td>
</tr>
</tbody>
</table>

Projected Pre-tax Returns on NAV

Pre-tax Projected Return on NAV

| Tax Rate on Retained Reinvested Earnings | 135,653 | 86,974 | 222,627 |
| Built-in Cap Gains Tax @ 38% rate       | $139,000 basis |
| Marketability Discount @ 27.5%          | 10.85% |

Firstly, we needed to generate assumptions as to the earnings and capital appreciation capacity of LEC’s investment portfolio. This is because a fundamental assumption of this particular methodology is that the liquidation proceeds realized in year five, for example, would be based upon the original net asset value of the portfolio increased by retained earnings and capital appreciation from previous years.

As can be observed above, we assume that LEC’s portfolio of investments, on a net asset value basis, would generate an average annual 10.98% return (composed of 6.69% current and 4.29% capital appreciation). Given the composition of LEC’s investments and our previous analysis of the Company’s earning capacity, we believe these assumptions are, if anything, aggressive but reasonable. We also assume that the tax rate on retained earnings would be 30%.

In addition to earnings and capital appreciation factors, we also make the same assumptions as we did in the previous methodology employed regarding the tax rate on the imbedded capital gains tax liability (38% with a basis of $139,000), the marketability discount not attributable to tax issues (27.5%) and the discount rate employed (10.85%).

Calculation of the Average Net Proceeds Available on a Present Value Basis

Given the basic assumptions above, we then generate a schedule which (1) calculates the net cash proceeds available after liquidation for each of the next 10 years, (2) we then “discount” those values to present value, and (3) then average them to determine the average fair market value of a 100% interest in LEC (see the schedule on the following page).
AVGARE TOTAL DISCOUNT FROM NAV UPON LIQUIDATION IN EACH OF THE NEXT 10 YEARS

<table>
<thead>
<tr>
<th>Year of Liquidation</th>
<th>NAV Inc/ (after tax)</th>
<th>NAV After Capital Appreciation</th>
<th>FMV After Liquidity Discount</th>
<th>+ Current Pre-tax Capital Gain Returns</th>
<th>- Built-in Tax Liability Realizable Proceeds</th>
<th>= Net Proceeds as % of NAV</th>
<th>PV of Net Proceeds for Lack of Markability Total Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>NM</td>
<td>2,027,044</td>
<td>1,469,607</td>
<td>0 (505,631)</td>
<td>-16,126,858</td>
<td>963,976</td>
<td>47.6%</td>
</tr>
<tr>
<td>Year 1</td>
<td>2,027,044</td>
<td>2,114,018</td>
<td>1,532,663</td>
<td>35,653 (505,631)</td>
<td>1,162,685</td>
<td>1,048,882</td>
<td>51.7%</td>
</tr>
<tr>
<td>Year 2</td>
<td>2,208,975</td>
<td>2,303,756</td>
<td>1,670,223</td>
<td>147,828</td>
<td>1,312,420</td>
<td>1,068,074</td>
<td>52.7%</td>
</tr>
<tr>
<td>Year 3</td>
<td>2,407,235</td>
<td>2,510,522</td>
<td>1,820,129</td>
<td>161,095</td>
<td>1,475,594</td>
<td>1,083,327</td>
<td>53.4%</td>
</tr>
<tr>
<td>Year 4</td>
<td>2,623,289</td>
<td>2,735,847</td>
<td>1,983,489</td>
<td>175,554</td>
<td>1,653,412</td>
<td>1,095,061</td>
<td>54.0%</td>
</tr>
<tr>
<td>Year 5</td>
<td>2,858,735</td>
<td>2,981,395</td>
<td>2,161,511</td>
<td>191,310</td>
<td>1,847,191</td>
<td>1,103,655</td>
<td>54.4%</td>
</tr>
<tr>
<td>Year 6</td>
<td>3,115,312</td>
<td>3,248,981</td>
<td>2,355,511</td>
<td>208,481</td>
<td>2,058,261</td>
<td>1,109,449</td>
<td>54.7%</td>
</tr>
<tr>
<td>Year 7</td>
<td>3,394,917</td>
<td>3,540,583</td>
<td>2,566,923</td>
<td>227,192</td>
<td>2,288,485</td>
<td>1,112,751</td>
<td>54.9%</td>
</tr>
<tr>
<td>Year 8</td>
<td>3,699,618</td>
<td>3,858,357</td>
<td>2,797,309</td>
<td>247,583</td>
<td>2,539,262</td>
<td>1,113,838</td>
<td>54.9%</td>
</tr>
<tr>
<td>Year 9</td>
<td>4,031,666</td>
<td>4,204,653</td>
<td>2,948,373</td>
<td>269,085</td>
<td>2,812,547</td>
<td>1,112,957</td>
<td>54.9%</td>
</tr>
<tr>
<td>Year 10</td>
<td>4,393,516</td>
<td>4,582,029</td>
<td>3,321,971</td>
<td>294,020</td>
<td>3,110,360</td>
<td>1,110,334</td>
<td>54.8%</td>
</tr>
</tbody>
</table>

**AVERAGE VALUES**

<table>
<thead>
<tr>
<th></th>
<th>1,083,846</th>
<th>53.5%</th>
<th>-46.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Net Asset Value</strong></td>
<td>2,027,044</td>
<td>100.0%</td>
<td></td>
</tr>
<tr>
<td><strong>Marketability Discount</strong></td>
<td>(557,437)</td>
<td>-27.5%</td>
<td></td>
</tr>
<tr>
<td><strong>Net Realizable Value of Upon Liquidation</strong></td>
<td>1,469,607</td>
<td>72.5%</td>
<td></td>
</tr>
<tr>
<td><strong>Present Value Weighted Built-in Cap Gains Tax</strong></td>
<td>(385,761)</td>
<td>-19.0%</td>
<td></td>
</tr>
<tr>
<td><strong>Average Net Realizable Value to Shareholders</strong></td>
<td>1,083,846</td>
<td>53.5%</td>
<td></td>
</tr>
</tbody>
</table>

We observe above that the net asset value, and therefore the net realizable cash proceeds, increase over time as LEC’s portfolio of investments increases in value due to retained earnings and capital appreciation. We also note that the built-in capital gains tax liability remains constant at $505,631. Finally we can observe that the net present value for each of the years calculated is fairly stable, averaging $1,083,846 or 53.5% of net asset value.

**Conclusion**

Given the above analysis, we conclude that the fair market value of the subject block of stock representing a 63% restricted control ownership interest LEC is as follows:

**Net Realizable Value to Equity Upon Total Liquidation**

| Beginning Net Asset Value | 2,027,044 | 100.0% |
| Marketability Discount | (557,437) | -27.5% |
| Net Realizable Value of Upon Liquidation | 1,469,607 | 72.5% |
| Built-in Cap Gains Tax | (385,761) | -19.0% |
| Net Realizable Value to Shareholders | 1,083,846 | 53.5% |

| 63% Interest | 63% |
| Fair Market Value of 63% Interest in LEC (Rounded) | $610,000 |

**Average Liquidation Over a Period of 10 Years**

| Immediate Liquidation | $680,000 |
| Average Liquidation | 76.3% |

Average Built-in Cap Gains Tax as % of Immediate Tax = 76.3%
Our conclusion of value represents a total discount for lack of marketability of 46.5%, of which 27.5% is attributable to factors other than tax issues and 19.0% is attributable to the imbedded built-in gains tax liability. Finally we note that the implied marketability discount due to the built-in capital gains tax liability at $385,761 represents 76.3% of the full imbedded tax of $505,631 due to the “time value of money.”

Therefore, under this particular appraisal methodology, we determine that the fair market value of the subject block of stock representing a 63% restricted control ownership interest in LEC is worth $680,000.

**Reconciliation of Valuation Conclusions**

We have viewed the fair market value of the subject block of stock under appraisal from three different valuation perspectives:

1. **FMV in immediate liquidation:** $610,000
2. **FMV contemplating a six-year orderly liquidation:** $720,000
3. **FMV using average PV of liquidation proceeds in each of the next 10 years:** $680,000

As discussed previously, we view the results of method #1 as setting a lower limit as to the fair market value of the subject block of stock. However, both methods 2 and 3 have taken into account the “time value of money” and provide a reasonable estimate of fair market value for the subject securities. Hence, we determine that the best estimate of the fair market value is $700,000.

---

**FINAL CONCLUSION OF FAIR MARKET VALUE**

63% Restricted Control Interest of LEC

<table>
<thead>
<tr>
<th>Description</th>
<th>$ Amount</th>
<th>% of Beg NAV</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Net Asset Value</strong></td>
<td>2,027,044</td>
<td>100.0%</td>
</tr>
<tr>
<td><strong>Marketability Discount for Other Than Tax Issues</strong></td>
<td>@ 27.5%</td>
<td>(557,437)</td>
</tr>
<tr>
<td><strong>Net Realizable Value of Upon Liquidation</strong></td>
<td>1,469,607</td>
<td>72.5%</td>
</tr>
<tr>
<td><strong>Marketability Discount for Imbedded CG Tax</strong></td>
<td>@ 17.6%</td>
<td>(357,214)</td>
</tr>
<tr>
<td><strong>Net Realizable Value to Shareholders - 100% of Stock</strong></td>
<td>1,112,393</td>
<td>54.9%</td>
</tr>
<tr>
<td><strong>Total Marketability Discount from NAV</strong></td>
<td>@ 45.1%</td>
<td></td>
</tr>
<tr>
<td><strong>Immediately Realized Capital Gains Tax</strong></td>
<td>(505,631)</td>
<td>100.0%</td>
</tr>
<tr>
<td><strong>Present Value Weighted Imbedded Capital Gains Tax</strong></td>
<td>(357,214)</td>
<td>70.6%</td>
</tr>
</tbody>
</table>

**Value of 63% Interest**                                     | $700,000 |
As indicated in the schedule on the opposite page, our final conclusion of fair market value represents a total discount for lack of marketability of 45.1%, of which 27.5% is attributable to factors other than tax issues and 17.6% is attributable to the imbedded built-in gains tax liability. The implied marketability discount due to the built-in capital gains tax liability at $357,214 represents 70.6% of the fully imbedded tax of $505,631 due to the "time value of money."

Given all of the analysis performed, our final conclusions regarding the fair market value of the subject securities appear to be reasonable and economically rational.

**Reasonability Test**

The combined discount for lack of control and lack of marketability was determined to be 45.1%. Since this determination involved a great many qualitative assumptions about the factors, their applicability and impacts, it is important to independently assess the reasonability of the conclusion.

*Partnership Spectrum*, published by Partnership Profiles of Dallas, Texas annually surveys sale prices of real estate limited partnership interests compared to their appraised net asset values (control values). This directly measures the combined discount for lack of control and lack of marketability, most of which is for marketability. This comparison is apt for the Company's shares because the secondary market for closely held interests is a brokered market, which is relatively thin and inefficient, there being limited buyers for any potential sales transaction. As a result, there are few and infrequent transactions and limited data available.

The markets for private real estate companies and publicly traded real estate limited partnerships are both relatively limited. However, the market for LEC's stock likely would not enjoy the same degree of exposure to the market and therefore would be much less marketable than shares in listed partnerships. In addition, these limited partnership interests, because of the nature of their pass-through tax status, do not have any embedded capital gains tax issues.

By contrast, the exchange-based market for securities of publicly traded real estate investment trusts (REITs) is not comparable to the market for small private real estate partnerships. The REIT market is far larger and deeper. Institutional investors dominate it. The typical REIT has a market capitalization far in excess of that of the typical limited partnership. According to a recent Goldman Sachs report, capital inflows into and the pace of merger activity in the industry have reached record levels. REITs differ fundamentally in numerous ways from limited partnerships: They are less risky because they are more diversified, they have larger investment-quality properties, more stable tenant mixes, are geographically more diverse, have deeper management and enjoy greater access to financing. Because the REIT market is liquid, discounts observed on REIT stocks relative to net fair market asset values reflect only lack of control and not lack of marketability. These discounts are therefore not suitable for comparison to the 45.1% combined discount for lack of both control and marketability developed above.

Regarding the discount data found in *Partnership Spectrum*, about fifteen independent firms make secondary markets in publicly traded limited partnerships. Three, of which the largest is the Chicago Partnership Board, account for sixty percent of trading activity. The average transaction size is less than $8,000, with 81 percent of all trades averaging less than $10,000. According to a study by Robert Strangor & Co., a leading real estate firm, sales of public real estate limited partnerships have declined from a peak of $8.5 billion in 1986 (the year in which significantly restrictive tax reforms were enacted) to $350 million in 1995, the latest date for which data were available prior to the valuation date of March 18, 1996.
Therefore our final analysis is a review of the reports in *Partnership Spectrum*, May/June 1996 (Exhibit 3) which indicates that non-distributing equity partnerships had an average discount to Net Asset Value of 56%. These values are based upon a hypothetical sale of the partnership property at appraisal values, and the distribution of the resulting net proceeds (less estimated selling costs) together with any other net assets. We note that the 56% cited in *Partnership Spectrum* is comparable to the 45.1% discount we developed for LEC. Since the *Partnership Spectrum* data reflects taking taxes into effect, no adjustment to that data is needed.

Hence, based upon all of the analyses performed for this appraisal, we conclude that LEC would expect to be sold at a 45.1% discount from the NAV if a willing buyer and willing seller were to negotiate a deal based upon reasonable and rational economic expectations.

**Final Conclusion**

In arriving at our final opinion of fair market value of a 63% restricted control interest with limited marketability in LEC, we considered all relevant factors based upon information known or susceptible of being known as of the effective valuation date. We therefore determine that the fair market value of the subject block of stock is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Asset Value</td>
<td>$2,027,044</td>
</tr>
<tr>
<td>Discount for Lack of Marketability (45.1%)</td>
<td>(914,651)</td>
</tr>
<tr>
<td>Non-Marketable Value of 100% of Equity</td>
<td>$1,112,393</td>
</tr>
<tr>
<td><strong>Non-Marketable Value of 63% of Equity</strong></td>
<td>$700,000</td>
</tr>
</tbody>
</table>

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