Estate of Natale B. Giustina, et al., v. Commissioner

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National Association of Certified Valuators and Analysts

Ninth Circuit Court of Appeals Reverses U.S. Tax Court

On December 5, 2014, the Ninth Circuit Court of Appeals "reversed and remanded for recalculation of value" a Tax Court Memo decision in *Estate of Natale B. Giustina, Deceased, v. Commissioner* (No. 12-71747). The case involves the valuation of a 41.128 percent partnership interest in Giustina Land and Timber Company Limited Partnership and raises important questions regarding the proper underlying assumptions to use probability weighting.

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The Tax Court in *Estate of Natale B. Giustina, et al., v. Commissioner*, TC Memo 2011-141, was asked to decide whether the fair market value of a 41.128 percent partnership interest in GLT, LP, reported on the estate and gift tax return of Natale B. Giustina, was $12,995,000, as reported by the estate, or $33,515,000, as contended by the commissioner of the Internal Revenue Service.

The Tax Court decision states, "By August 3, 2005 Giustina Land and Timber owned 47,939 acres of timberland in the area of Eugene, Oregon." The Tax Court proceeds to state:

The value of the timberlands, which constitute most of the partnership's assets, is agreed to be $142,974,438. As [Robert] Reilly testified, the optimal strategy to maximize the value of the partnership would be to sell the timberland and 'get $143 million today.' Selling the timberlands would generate about $143 million; continuing to operate the partnership would generate only about $52 million.

The government's expert expected "total future cash flows, once discounted to present value, would be $65,760,000. Robert Reilly, the estate's expert, estimated that annual cash flow would be $4,560,000 in the first year after Giustina's death. He estimated the total future cash flow, once discounted to present value, would be $33,800,000."

There is not sufficient information in either decision to understand how $142,974,438 in agreed current land values was reduced to $33,800,000 (per the estate's expert) or $65,760,000 per the government's expert, but, alas, the partners said they had no interest in liquidating the partnership, so the buyer of a minority interest could not force liquidation.

Judge Morrison of the Tax Court issued a decision June 22, 2011, that the fair market value of the partnership interest was $27,454,115.

The Ninth Circuit Appeals Court reversed and remanded the case stating:

The Tax Court concluded there was a 25% likelihood of liquidation of the partnership. It therefore gave a 25% weight to an asset-based valuation and a 75% weight to the valuation as a going concern. Although the Tax Court recognized that the owner of the limited partnership interest could not unilaterally force liquidation, it concluded that the owner of that interest could form a two-thirds voting bloc with other limited partners to do so, and assigned a 25% probability to that occurrence. This conclusion is contrary to the evidence in the record.

The Ninth Circuit decision went on to say:

[w]e do, however, hold that the Tax Court clearly erred by failing to explain its basis for cutting in half the Estate's expert's proferred company specific risk premium, even under the deferential clear error standard, 'in drawing its conclusions...the Tax Court is obligated to detail its reasoning.' *Estate of Trompeter*, 279 F.3d at 770.

We recognize that diversification of assets is a widely accepted mechanism for reducing company-specific risk. However, the Tax Court stated only that 'investors can eliminate such risks by holding a diversified portfolio of assets' without considering the wealth a potential buyer would need in order to adequately mitigate risk through diversification.

The Tax Court decision and the Appeals decision to reverse and remand both open interesting questions for valuators regarding how to value business interests where the Asset Approach exceeds the Income Approach. While the record is incomplete, what assumptions should valuation analysts use if the entity has operational issues but could be an attractive acquisition target?

The Tax Court opined there was a 25 percent probability the partnership would be dissolved at some future date as a "known or knowable" as of the valuation date, which should be considered by the valuator and included in the fair market value as of the date of death.

The Tax Court also concluded that if the partnership diversified, it could reduce the company specific risk significantly and improve its fair market value. The Appeals Court did not accept either argument, as proven by available evidence, although one might argue the terminal value of expected cash flows should include the eventual value from sale of the timberland that may exceed the expected total cash flow prior to that sale.

Did the Ninth Circuit get it right? Or should it have included expected cash flows of an eventual sale event because of the probability that reasonable investors would have eventually maximized their return by selling the timberland?

The Tax Court also questioned the discount rate selected by the estate's expert. The court accepted the risk free rate, the beta-adjusted equity risk premium, and the small stock equity risk premium but did not accept the partnership-specific risk premium of 3.5 percent, arguing instead that the partnership specific risk premium should have been lower because the partnership had the ability to diversify its holdings over time. The Tax Court exercised its discretion and then selected 1.75 percent as the appropriate added return using the Build-Up Method.

As for marketability discount, the Tax Court accepted the IRS expert's use of the SEC Institutional Investor Study reducing the marketability discount claimed by the estate's expert from 35 percent to 25 percent.

As valuators, our mission is to determine the fair market value using expected future cash flows. A lower tax burden for our clients cannot be our primary goal. "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Joseph D. Brophy, MBA, CPA/ABV, CVA, ABAR, CM &AA, is a former member of the AICPA IRS Practice and

Procedures Committee and former chair of the Texas Society of CPAs' Relations with IRS Committee. He is frequent writer for tax and valuation publications. Mr. Brophy can be reached at jdbrophy@jdbrophycpa.com or by phone at (214) 522-3722.

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