Estate of Giustina v. Commissioner

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In matters argued before the U.S. Tax Court, valuation professionals are frequently asked to provide opinions related to the value of closely held businesses and of fractional ownership interests in closely held businesses. This discussion relates to a recent appeal of a U.S. Tax Court decision involving such valuation issues. The case in question is Natale B. Giustina v. Commissioner. *In this case, the Tax Court's selection of the method for valuing a fractional ownership interest in a closely held business was appealed to the United States Court of Appeals for the Ninth Circuit. The Appeals Court reversed the decision and remanded it back to the Tax Court for further consideration.*

Introduction

The Giustina family was involved in timberland harvesting and growing business operations dating back to the early 1900s, when family ancestors emigrated from Italy to the United States.

At inception, the family business was operated as a construction company. The construction company was created to aid in the rebuilding effort after the 1906 San Francisco earthquake. In 1910, the company operations moved from San Francisco, California, to Portland, Oregon.

In 1917, the company purchased a lumber mill in Molalla, Oregon. In the 1920s, the company moved to Lane County, Oregon, where it operated an additional lumber mill near Dexter, Oregon. In an effort to expand its land base ownership, over the following years, the company acquired timberland and mills in the Eugene, Oregon, vicinity.

These timberland acquisitions built the foundation for future company operations. The Giustina family had a longstanding history of acquiring and harvesting large tracts of land in the Eugene, Oregon, area.

On January 1, 1990, the Giustina Land and Timber Company Limited Partnership ("the Partnership") was formed. The partnership agreement provided the general partners with complete control over the Partnership, including the rights to sell the Partnership's land and harvested products.

The partnership agreement stipulated that a general partner could only be approved or removed by limited partners owning at least two-thirds of the limited partnership.

The stated purpose of the Partnership, as provided by the partnership agreement, was to operate a sustained yield timber harvesting company, with the goal of passing Partnership ownership to future family generations. The partnership agreement also stated that the Partnership would continue doing business until December 31, 2040.

Case Background

Natale B. Giustina passed away on August 13, 2005, with a 41.128 percent limited partnership interest, ("Subject Interest"), in the Partnership.

At that time, the Partnership employed 15 full-time employees and was primarily engaged in the growing, harvesting, and selling of forestry products. The Partnership's primary holdings consisted of 47,939 acres of timberland in the Eugene, Oregon, area.

The United States Tax Court ("Tax Court"), as cited in the *Estate of Natale B. Giustina v. Commissioner*, determined the value of the Subject Interest. In order to make its determination, the Tax Court considered the following evidence as provided by the estate's expert and the Internal Revenue Service (the "Service") expert.

The Estate Expert's Position

The estate expert and the Service expert agreed that the total value of the timberland was worth $142,974,438 on a marketable, controlling ownership interest basis. This value included a 40 percent discount that was intended to address the time needed to sell the land.

The estate expert used three generally accepted valuation approaches and presented four generally accepted valuation methods to value the Partnership.

Based on an asset-based approach, and using an asset accumulation method, the estate expert concluded a value of $51,100,000 for the Partnership on a marketable, noncontrolling ownership interest basis. The estate expert selected a 10 percent weighting to apply to the asset-based approach indication to arrive at the fair market value conclusion for the Partnership on a marketable, noncontrolling value.

The estate expert presented two income approach methods:

1. The direct capitalization method
2. The capitalization of distributions method

The application of the direct capitalization method resulted in a marketable, noncontrolling value of $33,800,000 for the Partnership. The estate expert selected a 30 percent weighting to apply to the direct capitalization method indication in order to arrive at the fair market value conclusion for the Partnership on a marketable, noncontrolling value basis.

In Tax Court, the estate expert testified, "The optimal strategy to maximize the value of the Partnership would be to sell the timberland and get $143 million today, whereas continuing operations would only generate $52,100,000," using the capitalization of distributions method, the third generally accepted valuation method used in the estate expert's analysis.

The estate expert selected a 30 percent weighting for the capitalization of distributions method indication in order to arrive at the fair market value conclusion for the Partnership on a marketable, noncontrolling value basis.

For the fourth and final method, the estate expert presented a valuation using the guideline publicly traded company method to arrive at $59,100,000 on a marketable, noncontrolling basis. The estate expert selected a 30 percent weighting for the guideline publicly traded company method indication in order to arrive at the fair market value conclusion for the Partnership on a marketable, noncontrolling value basis.

Based on the selected weightings, the estate's expert concluded that the total value of the Partnership was $48,610,000, on a marketable, noncontrolling value basis.

In order to arrive at a nonmarketable, noncontrolling value, the estate expert selected a 35 percent discount for lack of marketability. Therefore, the concluded value of the 41.128 percent interest in the Partnership was $12,995,000.

The Service Expert's Position

The Service expert used three generally accepted valuation approaches and presented three generally accepted valuation methods to value the Partnership.

Based on an income approach, discounted cash flow method, the Service expert concluded that the Partnership was worth $65,760,000 on a marketable, controlling basis. The Service expert selected a 20 percent weighting for the discounted cash flow method.

Based on a market approach, guideline publicly traded company method, the Service expert concluded that the Partnership was worth $99,550,000 on a marketable, controlling basis. The Service expert selected a 20 percent weighting for the guideline publicly traded company method.

Based on an asset-based approach, using the net asset value method, the Service expert concluded that the Partnership was worth $150,680,000 on a

marketable, controlling basis. The Service expert selected a 60 percent weighting for the net asset value method.

Based on the selected weightings, the Service's expert concluded that the total value of the Partnership was $123,470,000 on a marketable, controlling value basis.

The Service expert concluded that the total value of the Partnership after discounts (34 percent combined discount for lack of marketability and lack of control) was $81,490,200.

The Service expert concluded that the value of a 41.128 percent partnership interest in the Partnership was $33,515,000.

The Tax Court Decision

Ultimately, the Tax Court used two generally accepted valuation approaches and presented two generally accepted methods to value the Partnership.

Based on the income approach and the discounted cash flow method, the Tax Court valued the Partnership at $51,702,857 on a marketable, noncontrolling basis. In order to conclude on this value indication, the Tax Court developed its own present value discount rate including the selection of a partnership-specific risk premium.

The Tax Court then selected a 75 percent weighting to apply to the discounted cash flow method indication in order to arrive at the fair market value conclusion for the Partnership on a marketable, noncontrolling value basis.

Based on an asset-based approach and the net asset value method, the Tax Court valued the Partnership at $150,680,000. In this case, the Tax Court essentially accepted the Service expert's asset-based approach conclusion.

The Tax Court then selected a 25 percent weighting to apply to the net asset value method indication in order to arrive at the fair market value conclusion for the Partnership on a marketable, controlling value basis.

The Tax Court reasoned that an owner of a 41.128 percent interest in the Partnership could effectuate a sale by various means. In this case, the Tax Court estimated the probability of a sale to be 25 percent.

The Tax Court selected a 25 percent marketability discount, but it only applied the discount to the income approach estimate.

After the application of the 25 percent marketability discount, as applied to the income approach estimate, the concluded value of the Partnership was $66,752,857 on a purported nonmarketable, minority basis.

The Tax Court concluded that the value of a 41.128 percent partnership interest in the Partnership was $27,454,115.

The Ninth Circuit Court of Appeals Decision

The appellate decision related to the *Estate of Natale B. Giustina v. Commissioner of Internal Revenue*,[2] was filed December 5, 2014, as an unpublished opinion. In its unpublished opinion, the United States Court of Appeals for the Ninth Circuit ("Ninth Circuit") reversed and remanded to the Tax Court for recalculation of its valuation of a 41.128 percent interest in the Partnership.

In its opinion, the Ninth Circuit addressed the Tax Court's use of valuation methods, the selected weightings, the selected valuation discounts, and the selected company-specific risk premium as part of an equity cost of capital calculation.

Valuation Methods and Selected Weightings

As previously mentioned, to arrive at the value of the Subject Interest the Tax Court selected a 75 percent weighting to apply to the income approach value indication. This value was intended to conclude on a value of the Partnership as a going-concern business operation.

The Tax Court selected and applied a 25 percent weighting for the asset-based approach value indication. This value was intended to present a value that accounted for the likelihood of liquidation.

The Tax Court acknowledged that the owner of the limited interest could not unilaterally force liquidation, but concluded that the owner of the limited interest could assemble a two-thirds voting block with other limited partners, and assigned a 25 percent chance of occurrence.

According to the Ninth Circuit, the Tax Court conclusion that the Subject Interest could liquidate the Partnership is contrary to the evidence in the record.

The Ninth Circuit reasoned that the Tax Court was in error based on the following statement:

> In order for liquidation to occur, we must assume that (1) a hypothetical buyer would somehow obtain admission as a limited partner from the general partners, who have repeatedly emphasized the importance that they place upon continued operation of the Partnership; (2) the buyer would then turn around and seek dissolution of the partner-

ship or removal of the general partners who just approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that no limited partner ever asked or ever discussed the sale of an interest.

The Ninth Circuit considered the Tax Court's error in selecting a 25 percent likelihood of hypothetical events. Other Tax Court judges have made similar errors.

The Ninth Circuit discussed this error in the follow quote:

> Alternatively, we must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution. We conclude that it was clear error to assign a 25 percent likelihood to these hypothetical events. As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), **the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners** [emphasis added]. See also *Olson v. United States*, 292 U.S. 246, 257 (1934) (explaining in a condemnation case that, when a court estimates "market value," "[e]lements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable[,] should be excluded from consideration"). We therefore remand to the Tax Court to recalculate the value of the Estate based on the partnership's value as a going concern.

Tax-Affecting Pass-Through Entities

The valuation consideration of selecting and using an income tax rate for valuation of pass-through entities remains a controversial topic in valuations performed for tax purposes. Because the Partnership is a pass-through entity, for income tax purposes, partnership earnings are taxed at the partner level of ownership and not at the corporate level.

Because the estate expert applied public-company-derived rates of return that were based on public company after-tax returns, the estate expert applied an income tax rate to the Partnership earnings prior to calculating the cash flow used in the income approach.

In this case, the estate expert applied a 25 percent income tax rate (approximately equal to the marginal Partnership unitholder federal and Oregon state income tax rate) resulting in a normalized net income used in calculation of the normalized cash flow.

The decision to subtract income tax related to the valuation of a pass-through entity will continue to be a controversial issue. According to the Ninth Circuit, as presented in their unpublished opinion, in regard to tax-affecting pass-through entity cash flows:

> The Estate claims that the Tax Court clearly erred by using pretax cash flows for the going-concern portion of its valuation. The Estate admits in its brief that "tax-affecting is . . . an unsettled matter of law."

However, in this case, apparently because the estate suggested that tax-affecting is an unsettled matter, the Ninth Circuit found that tax-affecting the net income was not appropriate.

Discounts for Lack of Marketability

It is generally accepted that an investment is worth more if it is readily marketable and, conversely, worth less if it is not readily marketable. The difference in price an investor will pay for a liquid asset compared to an otherwise comparable illiquid asset is often substantial.

This difference in price is commonly referred to as the discount for lack of marketability.

The discount for lack of marketability measures the difference in the expected price of (1) a liquid asset (the benchmark price measure) and (2) an otherwise comparable illiquid asset (the valuation subject).

It is true that there are varying degrees of investment marketability. An ownership interest in an actively traded security can typically be converted into cash within three business days of the sell decision. This is the typical investment benchmark for a fully marketable security.

At the other end of the investment marketability spectrum is an ownership interest in a privately owned company. In this case, the company (1) pays no dividends or other distributions, (2) requires capital contributions, and (3) limits ownership of the company to certain individuals.

While both the Tax Court and the Estate agreed that the Subject Interest suffered from lack of marketability, the appropriate level of discount was an item of debate.

The Ninth Circuit agreed with the Tax Court's selected discount for lack of marketability as noted in the following statement:

> Further, the Tax Court did not clearly err by using the Commissioner's proposed 25% marketability discount rather than the Estate's proffered 35% discount, *see, e.g., Estate of O'Connell v. Comm'r*, 640 F.2d 249, 253 (9th Cir. 1981), especially considering that the Estate's expert acknowledged that such discounts typically range between 25% and 35%.

Company-Specific Risk Premium

In general, there may be various company-specific risk factors that surround an investment in a partnership interest. According to the estate expert, the following factors relate specifically to an ownership interest in the Partnership:

1. The Partnership is significantly smaller than the average size of the companies used to estimate the small stock equity risk premium adjustment.
2. The Partnership timberland assets are all located in Oregon and, therefore, not geographically dispersed.
3. The Partnership had nondiversified operations with one source of revenue (timber harvesting).
4. The Partnership timberland assets are managed on a sustained yield basis to optimize forest growth and long-term asset value.

Based on these company-specific, or in this case partnership-specific, risk factors, the estate expert added a 3.5 percent risk premium to the equity cost of capital calculation. The Tax Court decreased the company-specific risk premium to 1.75 percent, however it did not adequately explain its reasoning for doing so.

Because the Tax Court did not explain why it decreased the company-specific risk premium, as a component of the equity cost of capital calculation, the Ninth Circuit found that the Tax Court erred as referencing the following paragraph:

> We do, however, hold that the Tax Court clearly erred by failing to adequately explain its basis for cutting in half the Estate's expert's proffered company-specific risk premium. Even under the deferential clear error standard, "[i]n 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 commonly used to reduce company-specific risk. However the Tax Court stated only that "investors can eliminate such risks by holding a portfolio of diversified assets," without considering the wealth a potential buyer would need in order to adequately mitigate risk through diversification.

Summary and Conclusion

The significance of this judicial decision is that it involved a company that had a much greater value in liquidation than as a going concern. It is also significant that the Tax Court was not allowed to impart a so-called imaginary scenario in order to arrive at a value calculation.

In general, the Ninth Circuit found that the Tax Court erred in several aspects of its valuation calculation. One way to look at this matter is to consider that the Tax Court attempted to move away from the fair market value standard to arrive at the Subject Interest value.

As commonly defined in valuation literature, fair market value is the price at which a 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, with both parties having reasonable knowledge of relevant facts.

In this matter, the Tax Court made assumptions regarding the likelihood of an ability to force liquidation and the ability to diversify the Partnership's asset holdings.

None of these assumptions were in the control of the noncontrolling Subject Interest. Therefore, by applying specific assumptions the Tax Court essentially concluded on an investor-specific value and not a fair market value.

The Ninth Circuit reversed and remanded the *Estate of Giustina, et al. v. Commissioner* back to the Tax Court for recalculation. One clear take-away from this Tax Court matter is that, as the valuation profession and legal environment continue to evolve, certain historical issues remain unsettled.

Notes:

1. Estate of Natale B. Giustina v. Commissioner, T.C. Memo 2011-141.
2. Estate of Natale B. Giustina v. Commissioner of Internal Revenue, United States Court of Appeals for the Ninth Circuit, case number 12-71747.

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