Estate of Giustina v. Commissioner— Round 3

Christopher M. Silvetti

A previous discussion of the Estate of Giustina v. Commissioner *case was presented in the summer of 2015* Insights *issue. At that time, the case was on appeal to the U.S. Court of Appeals for the Ninth Circuit. The Ninth Circuit reversed and remanded the case back to the U.S. Tax Court for recalculation. This discussion summarizes the original facts presented in the case and the updated findings concluded by the U.S. Tax Court in a supplemental memorandum opinion on June 13, 2016.*

Introduction

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

At its 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. The goal of the Partnership was to pass the Partnership ownership on to future family generations. The Partnership agreement also stated that the Partnership would continue operating as a business until December 31, 2040.

Case Background

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

At that time, the Partnership employed 15 full-time employees, and it 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 U.S. Tax Court (the "Tax Court"), as cited in the *Estate of Natale B. Giustina v. Commissioner*,[1] determined the value of the Subject Interest.

In its determination, the Tax Court considered the testimony evidence as provided by the estate's valuation expert and by the valuation expert of the Internal Revenue Service (the "Service").

The Estate's Position

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

The estate's valuation expert relied on three generally accepted valuation approaches and presented four generally accepted valuation methods to estimate the value of the Partnership.

Based on an asset-based approach, applying the net asset value method, the estate's expert concluded a value of $51,100,000 for the Partnership on a noncontrolling, marketable ownership interest basis.

The estate's valuation expert selected a 10 percent weighting to apply to the asset-based approach value indication to arrive at the fair market value conclusion for the Partnership on a noncontrolling, marketable value basis.

The estate's valuation expert presented two income approach valuation methods:

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

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

In Tax Court, the estate's valuation expert testified that "[t]he 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 valuation expert's analysis.

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

For the fourth and final valuation method, the estate's valuation expert presented a valuation applying the guideline publicly traded company method to arrive at $59,100,000 on a noncontrolling, marketable value basis.

The estate's valuation expert selected a 30 percent weighting for the guideline publicly traded company method value indication in order to arrive at the fair market value conclusion for the Partnership on a noncontrolling, marketable value basis.

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

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

The Service's Position

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

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

Based on a market approach, applying the guideline publicly traded company method, the Service expert concluded that the Partnership had a fair market value of $99,550,000 on a controlling, marketable value basis.

The Service valuation expert selected a 20 percent weighting for the guideline publicly traded company method.

Based on an asset-based approach, applying the net asset value method, the Service valuation expert concluded that the Partnership had a fair market value of $150,680,000 on a controlling, marketable value basis.

The Service valuation expert selected a 60 percent weighting for the net asset value method.

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

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

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

The Tax Court's Original Decision

Originally, the Tax Court used two generally accepted valuation approaches—and presented two generally accepted valuation methods—to estimate the value of the Partnership.

Based on an income approach, and the discounted cash flow method, the Tax Court estimated the value of the Partnership at $51,702,857 on a noncontrolling, marketable value basis.

In order to conclude 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 noncontrolling, marketable value basis.

Based on an asset-based approach, the net asset value method, the Tax Court estimated the value of the Partnership at $150,680,000 on a controlling, marketable value basis.

In this case, the Tax Court essentially accepted the Service valuation expert's asset-based approach value 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 controlling, marketable 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 discount for lack of marketability, but the court only applied the discount to the income approach estimate of value.

After the application of the 25 percent discount for lack of marketability, as only applied to the income approach estimate of value, the concluded fair market value of the Partnership was $66,752,857 on a purported noncontrolling, nonmarketable value 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*,[2] was filed December 5, 2014, as an unpublished opinion.

In its unpublished opinion, the U.S. Court of Appeals for the Ninth Circuit (the "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 partnership-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 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 partnership 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 following 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 a corporate income tax rate for the valuation of pass-through entities remains a controversial topic for 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's expert applied public-company-derived rates of return that were based on public company after-tax returns, the estate's valuation expert applied a corporate income tax rate to the Partnership earnings prior to calculating the cash flow used in the income approach.

In this case, the estate valuation 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 its unpublished opinion, in regard to tax-affecting pass-through entity cash flow:

> 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, because the estate suggested that tax-affecting is an unsettled matter, the Ninth Circuit found that tax-affecting the net income was not appropriate.

Discount 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 Partnership:

1. pays no dividends or other distributions,
2. requires capital contributions, and
3. limits ownership of the Partnership 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%.

Partnership-Specific Risk Premium

In general, there may be various partnership-specific risk factors that surround an investment in a partnership interest.

According to the estate valuation 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 partnership-specific risk factors, the estate's expert added a 3.5 percent risk premium to the equity cost of capital calculation. The Tax Court decreased the partnership-specific risk premium to 1.75 percent; however, it did not sufficiently explain its reasoning for doing so.

Because the Tax Court did not explain why it decreased the partnership-specific risk premium, as a component of the equity cost of capital calculation, the Ninth Circuit found that the Tax Court erred as indicated by 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 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's Supplemental Opinion

At the direction of the Ninth Circuit, the Tax Court adjusted its opinion to implement the remand from the Ninth Circuit. Summarized below are the series of tasks performed by the Tax Court to implement the remand from the Ninth Circuit Supplemental Memorandum Opinion ("Supplemental Opinion"):[3]

- We adjust our valuation of the 41% limited-partner interest to give no weight to the value of the assets owned by the partnership.
- We further explain our original reason for reducing the partnership-specific risk premium from 3.5% to 1.75%.
- We hold that our original reason is not valid because it is inconsistent with the Ninth Circuit's opinion. We adjust our valuation of the 41% limited-partner interest to incorporate a partnership-specific risk premium of 3.5%.
- We recalculate our valuation of the 41% limited-partner interest as $13,954,730. This is the result of: (1) giving no weight to the value of the assets owned by the partnership and (2) using a partnership-specific risk premium of 3.5%.

The first adjustment the Tax Court made was to update the weighting applied to the assets owned by the Partnership. As stated above, the Tax Court originally adopted a 25 percent weighting that the Partnership would liquidate and sell its assets after the Subject Interest was transferred to a hypothetical willing buyer.

Applying the Ninth Circuit's recommendation to "recalculate the value of the Estate based on the partnership's value as a going concern,"[4] the Tax Court implemented the Ninth Circuit's "instruction by changing the weight we accord to the present value of cash flows from 75% to 100%."[5]

In applying the Ninth Circuit's recommendations, the Tax Court disregarded the previously applied liquidation method and accorded greater weight to the cash flow of the Partnership.

This decision greatly benefits the taxpayer, but the application of a 100 percent weighting to the discounted cash flow method is significant in that it contradicts the Service's Revenue Ruling 59-60, which states the following:

> The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. **The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal** [emphasis added]. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. **For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity,** [emphasis added]

The second adjustment the Tax Court made was related to the partnership-specific risk premium. In the Supplemental Opinion, the Tax Court provided further explanation for its rationale for halving the estate valuation expert's 3.5 percent partnership-specific risk premium.

The Service's Revenue Ruling 59-60 clearly defines the hypothetical willing buyer and willing seller concept, but the additional support provided by the Tax Court contradicts the definition of willing buyer and willing seller.

The Tax Court decision stated the following:

> The Court of Appeals opinion, in discussing the possibility that a hypothetical buyer could force the sale of the partnership's assets, held that the hypothetical buyer must be a buyer to whom a transfer of a limited-partner interest is permitted under section 9.3 of the partnership agreement. **By the same token, in evaluating the hypothetical buyer's ability to diversify risk, we should consider only a buyer whose ownership of a limited-partner interest is permitted by section 9.3 of the partnership agreement.** [emphasis added]

It is noteworthy that most limited partnerships have a clause related to the restrictions associated with the sale of limited partnership units and that limited partnership units may only be sold to current partners. This assumption unequivocally repudiates the foundation of the willing buyer and willing seller relationship.

It is also important to note that the Tax Court clarified its assumption relating to halving the estate valuation expert's partnership-specific risk premium. The Ninth Circuit found "that an investor could diversify assets 'without considering the wealth a potential buyer would need in order to adequately mitigate risk through diversification.'"[6]

The Tax Court explained its opinion as follows:[7]

> In evaluating the potential buyer's ability to diversify the risks associated with the partnership, we assumed that the buyer could be an entity owned by multiple owners. Examples of such an entity include a publicly-traded timber company, a real-estate investment trust, or a hedge fund. The unique risk associated with the 41% limited-partner interest would have been diversified because the entity's owners—wealthy or not—could hold other assets outside the entity.

After further explaining the rationale for halving the estate valuation expert's 3.5 percent partnership-specific risk premium, the Tax Court implemented the estate valuation expert's 3.5 percent partnership-specific risk premium.

Finally, the third adjustment the Tax Court made was to recalculate the 41.128 percent limited Partnership interest.

After assigning a 0 percent weighting to the net asset value method and a 100 percent weighting to the discounted cash flow method, clarifying their original rationale for halving the estate valuation expert's partnership-specific risk premium, and implementing the estate expert's 3.5 percent partnership-specific risk premium, the Tax Court concluded that the total fair market value of the Partnership was $45,240,000 on a noncontrolling, marketable value basis.

The Tax Court then applied a 25 percent discount for lack of marketability and concluded that the total value of the Partnership was $33,930,000 on a noncontrolling, nonmarketable value basis.

The Tax Court's recalculated fair market value for the Subject Interest was $13,954,730 on a noncontrolling, nonmarketable value basis—7.4 percent higher than the estate valuation expert's value conclusion.[8]

Summary and Conclusion

The significance of this judicial decision is that it involved a partnership 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 fair market value indication.

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 the 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 could have been effectuated by the noncontrolling Subject Interest. Therefore, by applying specific assumptions, the Tax Court originally concluded on an investor-specific value and not a fair market value.

On remand, the Tax Court adjusted its assumptions considering the Ninth Circuit's opinion regarding the assigned weight of the net asset value method, the assigned weight of the discounted cash flow method, and the partnership-specific risk premium.

Eleven years after the death of Natale B. Giustina, the Supplemental Opinion appears to be a windfall conclusion for the taxpayer.

<u>Notes:</u>

1. Estate of Giustina v. Commissioner, T.C. Memo 2011-141 (June 22, 2011).
2. Estate of Giustina v. Commissioner, 586 Fed. Appx. 417 (9th Cir. 2014).
3. Estate of Giustina v. Commissioner, 111 T.C.M. 1551 (2016).
4. Id.
5. Id.
6. Estate of Giustina v. Commissioner, 586 Fed. Appx. 417.
7. Estate of Giustina v. Commissioner, 111 T.C.M. 1551.
8. Id.

Christopher M. Silvetti is an associate in the Chicago office. Christopher can be reached at (773) 399-4322 or at cmsilvetti@willamette.com.