PERKINS & CO

FCG VALUATION CASE E-FLASH

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Issue 13:10

Estate of Natale B. Giustina, Deceased, Laraway Michael Giustina, Executor, Petitioner, v. Commissioner of Internal Revenue, Respondent
Docket No. 10983-09, T.C. Memo 2011-141, Judge: Hon. Richard T. Morrison, June 22, 2011

The court faulted taxpayer's expert for using a pretax discount rate while simultaneously reducing cashflows for income taxes when valuing a limited partnership owning timberland. While the Tax Court used the taxpayer-expert's discounted cash flow method, it recomputed the result using a slightly lower company-specific risk premium and did not tax affect the company's income.

Additionally, the Tax Court selected a smaller discount for lack of marketability ("DLOM") than taxpayer's expert. Because the taxpayer's expert did not rebut the IRS expert's testimony regarding the DLOM, the Tax Court accepted the IRS expert's DLOM

TAKEAWAY

Following Gross v. Commissioner (TCM 1999-254) and its progeny, the Tax Court has again concluded that the adverse economic impact associated with the income tax liability generated by a pass-through tax entity's income should not be considered in a business valuation. Failure to recognize that income tax distributions reduce net cash flow to equity in pass-through entities results in an overstatement of economic income and a mismatch with discount rates (derived from sources such as Ibbotson and Duff & Phelps) used to determine the present value of those cash flows.

THE FACTS

Natale B. Giustina ("Mr. Giustina" or the "Decedent") owned – through a revocable trust – a 41.128-percent limited partnership interest in Giustina Land & Timber Co., Limited Partnership ("GL&T" or the "Partnership"). The Partnership, along with two other partnerships owned by Mr. Giustina's family, owned timberland in the Eugene, Oregon, area.

The partnership agreement ("Agreement") for GL&T stipulated that the general partners (Mr. Giustina was not one) had full control of the business activities of the Partnership. Only the general partners had the ability to sell GL&T's timber, land, and other property.

GL&T's limited partnership interests had very restricted rights, including requiring general partners' approval for admission as a limited partner upon transfer of a limited partnership interest. However, limited partners owning two-thirds of the interests in the Partnership could remove a general partner, assign a successor general partner, and vote to dissolve GL&T. If the Partnership was dissolved, the Agreement required the distribution of either the assets of the Partnership or the proceeds from the sale of the assets to be pro-rata. On August 13, 2005 (the valuation date and date of death), Mr. Giustina's interest could combine with two other limited partnership interests to form a two-thirds supermajority, remove either general partner, assign a successor general partner, and/or dissolve GL&T.

The Partnership had a buy-sell agreement which gave existing limited partners the right of first refusal for all proposed transfers of limited partnership interests.

DISCUSSION
Of the methods used by each party's expert, the Tax Court ruled that the discounted cashflow ("DCF") and net asset value ("NAV") methods were the most helpful in determining a value for the subject interest. Both experts conceded the value of the timberlands owned by the Partnership was almost $143 million (over $150 million for all of GL&T's assets), which included a 40-percent discount related to delays associated with selling approximately 48,000 acres of timberland.

As a result of the preceding, the major differences between the two experts' concluded values were: 1) the calculation of cashflows used in the DCF, 2) DLOM, and 3) weighting of the various methods. Additionally, the court considered whether a penalty under IRC § 6662 was appropriate.

Discounted Cashflows Method
The Tax Court found the IRS expert's DCF method unpersuasive. First, the court agreed with the taxpayer-expert's rebuttal report indicating an internal inconsistency between the cashflow estimate and the effect of the discount for lack of control. Second, the Tax Court determined that using fixed operating expenses while revenues increased was unrealistic. Third, the court was not convinced it was appropriate to use actual results from the most recent period in determination of future cashflows. Accordingly, the Tax Court gave little weight to the IRS expert's DCF conclusion.

While the court believed that taxpayer-expert's use of five years of cashflows to extrapolate future cashflow was more appropriate, the Tax Court found numerous problems with the taxpayer-expert's DCF as well. The first problem the court noted was taxpayer-expert's use of a 25-percent reduction in cashflow to account for income taxes an owner would owe on a pro-rata share of partnership income. Citing Gross v. Commissioner, the court stated:

> The 25-percent reduction is inappropriate because the rate at which [taxpayer expert] discounted the cashflows to present value was a pretax rate of return, not a posttax rate of return. An appraiser should not reduce cashflows by income tax while simultaneously using a pretax rate of return to discount the cashflows to present value. [insertion substituted for expert's name]

Additionally, the court reduced taxpayer-expert's company-specific risk premium. In particular, the Tax Court noted that the expert's 3.5-percent premium reflected the unique risks of GL&T, but the court then asserted that such unique risks can be eliminated by holding a diversified portfolio. Because the court believed that company-specific risk can be ameliorated by diversification, the Tax Court reduced the discount rate by 1.75 percent, and concluded that a net company-specific risk premium of 1.75 percent was appropriate.

The court then recalculated the DCF using taxpayer-expert's assumptions - with the exception of the income tax deduction and the reduced discount rate - which increased taxpayer-expert's concluded DCF value from $33.8 million to more than $51.7 million.

Discount for Lack of Marketability
Regarding the DLOM, both the taxpayer and IRS experts used pre-IPO and restricted stock studies to determine their respective DLOMs.

Taxpayer-expert's 35-percent DLOM was more influenced by the pre-IPO studies than the restricted stock studies, yet also testified that the IRS's 25-percent DLOM was reasonable.

In contrast, the IRS's expert relied heavily upon the restricted stock studies because, according to his testimony, pre-IPO studies "tend to overstate their discount for just lack of marketability." As a result, his 25-percent DLOM was based largely on the conclusions in the SEC Institutional Investor Study. The Tax Court

sided with the IRS's expert because the taxpayer's expert "did not rebut [the IRS's expert]'s testimony that the pre-IPO studies overstated the discount for lack of marketability." [insertion substituted for expert's name] It should be noted the court assigned the 25-percent DLOM only to the value determined in DCF, not to any other method weighted by the Tax Court.

<u>Method Weighting</u>
Although both taxpayer and IRS experts gave only 30% and 20% weighting to the DCF, the Tax court decided that there was a 75% likelihood that the GL&T would continue its operations rather than liquidating its assets. Accordingly, the court gave a 75% weighting to the DCF.

The Tax Court then assigned a 25% weighting to the NAV (approximately $150 million for the value of all the Partnership's assets). Although the court acknowledged taxpayer-expert's testimony that the subject interest could not force liquidation of the assets, "there are various ways in which a voting block of limited partners with a two-thirds interest in the partnership could cause the sale."

Interestingly, neither party addressed whether the general partners would admit a transferee of the subject interest as a limited partner. If the transferred interest's rights were limited to financial interests (only), it may not have been able to combine with another interest to liquidate the assets. Even so, the court's assignment of a 25% weight to the method may have considered the preceding issue.

Other factors which may have affected the court's 25% weighting included:

- There was no indication that liquidation of GL&T's assets was imminent or contemplated.
- Given the 15-year history of the Partnership and the 80-plus-year history of the Decedent's family in the lumber industry, it would be unlikely that the Partnership's business activities would cease.

The Tax Court rejected the taxpayer-expert's capitalization-of-distributions method because the court decided "the cash earned by the partnership is more reliable indicator of value than the cash distributed to the partners." The method was found to be essentially duplicative of the DCF.

Finally, the Tax Court rejected the guideline publicly traded company method used by both experts. The court faulted both individuals for failing to appropriately consider that the selected public companies had business models too dissimilar from GL&T to be comparable.

<u>IRC § 6662 Determination</u>
Although the value calculated by the court was more than twice the value included on the Decedent's estate tax return, the Tax Court determined no penalty was appropriate. The court noted the "valuation was made in good faith and with reasonable cause" and therefore waived any penalty under IRC § 6662.

CONCLUSION
On its Form 706, Mr. Giustina's Estate asserted a $12,678,117 fair market value for the Decedent's 41.128-percent limited partnership interest, as determined by the taxpayer's expert. The IRS expert calculated a value of $35,710,000. Based on its expert's value, the IRS determined a $12,657,506 deficiency and declared a $2,531,501 penalty under IRC § 6662.

At trial, the Estate contended the value of the interest was $12,995,000 (slightly larger than the value on the estate tax return), while the IRS concluded the value was $33,515,000 (slightly smaller than the notice of deficiency).

In contrast to the parties' positions, the Tax Court determined the fair market value of the subject interest by applying a 75% weight to the DCF method ($51.7 million less 25% DLOM) and a 25% weight to the $150 + million NAV method (with no DLOM applied) for a $27.5 million fair market value of the subject 41.128-percent limited partnership interest.

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