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Estate of Natale B. Giustina, Deceased, Laraway Michael Giustina, Executor, Petitioner, v. Commissioner of Internal Revenue, Respondent
(hereinafter, "*Giustina II*")

Docket No. 10983-09, T.C. Memo 2016-114
Judge: Hon. Richard T. Morrison, June 13, 2016

OVERVIEW

The U.S. Court of Appeals for the Ninth Circuit remanded to the Tax Court *Estate of Giustina v. Commissioner*, T.C. Memo 2011-141 ("*Giustina I*"), disagreeing with the trial court's ruling on the following issues:

- the cost approach should not have been weighted with the income approach to determine fair market value, and
- the discount rate's "company-specific risk premium" should not have been reduced from 3.5% to 1.75%.

***e-Flash* Takeaway**
As is often the case with noncontrolling ownership interests in asset-intensive, agricultural-based entities (e.g., timberland, farms, ranches), the discounts from a pro rata share of 100% of the equity can be quite severe under the federal statutory fair market value standard of value. More specifically, the Tax Court ruled a 77% total discount was appropriate in *Giustina II*. The author is aware of five other Tax Court rulings involving eight separate agricultural-industry entities which had an average 66% total discount.

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

In its original ruling, the Tax Court concluded the asset and income approaches should be given 25% and 75% weightings, respectively, to reflect the possibility that the Decedent's interest could combine with two other existing ownership interests to liquidate the Partnership (i.e., the asset approach). The Appeals Court found such an event to be unlikely given the intent of the other owners. Hence, the revised decision only considered the income approach.

Additionally, the Appeals Court found the Tax Court's decision to reduce the "company-specific risk premium" component of the discount rate to be unsupported. Accordingly, the revised opinion reverted to the taxpayer-expert's selection for the risk premium.

After incorporating the above, the Tax Court's original conclusion of $27,454,115 was reduced to $13,954,730.

COMMENTARY

As was the case with the original *Giustina I* ruling, the author is particularly concerned that *Giustina II* failed to tax affect income when using the income approach to value a pass-through tax entity such as the Partnership. Quoting *Giustina I*:

> One problem with [taxpayer expert's] computations is that he reduced each year's predicted cashflows by 25 percent to account for the income taxes that would be owed by the owner of the partnership interest on that owner's share of the partnership's income. 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 post tax 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]

Reading the original court ruling, it appears the taxpayer's expert used the modified capital asset pricing model to determine a discount rate. Such a rate reflects the satisfaction of entity and personal taxes. Contrary to the court's observation in the preceding paragraph, such a discount rate is not a pretax rate. Hence, it is inappropriate to apply such a discount rate to a pretax income stream, as was done in the Tax Court's original and revised rulings. Failure to properly match the economic income stream available to the subject ownership interest with the economic income stream from which the discount rate was derived resulted in an overstatement of value in both rulings.

As noted in the *e-Flash* Takeaway, above, the total discount for the subject ownership interest was 77% of a pro rata share of 100% of the Partnership's equity value. In part, the Tax Court correctly concluded the severe discount could be justified because the subject noncontrolling ownership interest could not readily access the value of GL&T's underlying timberland assets. Absent a liquidation or sale event, which was not likely, the source for an investor's return on investment was current income.