TAX COURT CASE UPDATE

Citation:

Estate of Natale B. Giustina v. Commissioner, T.C. Memo 2011-141, June 22, 2011.

Overview:

The Tax Court determined the value of a 41.128 percent limited partnership interest as well as the applicability of an IRS §6662 penalty.

The Facts:

The Decedent passed away on August 13, 2005. At this date, his revocable trust owned a 41.128 percent limited partner interest in Giustina Land & Timber Co. Limited Partnership ("The LP"). The LP was formed on January 1, 1990 and consisted of 51.875 percent of the assets of Giustina Bros. and Giustina Timber Co., which owned timberlands. There were other partnerships created at the same time, but were not part of this case.

Since 1990, The LP operated under a written partnership agreement which was amended several times. At The Decedent's date of death, The LP owned 47,939 acres of timberland and employed 12 to 15 people.

The estate filed Form 706 reporting the value of The Decedent's interest as $12,678,117. On April 3, 2009, the IRS issued a deficiency notice in the amount of $12,657,506 and a §6662 penalty in the amount of $2,531,501. The IRS claimed that the LP interest was worth $35,710,000. At trial, The Decedent claimed that the partnership interest was worth $12,995,000.

Discussion:

Both The Decedent and the IRS hired valuation experts. The Decedent's expert used four methodologies: asset-accumulation method, cash flow method, capitalization of distributions method, and price-of-the-shares-of-other-companies method[i]. The IRS's expert used a cash flow method, a price-of-the-shares-of-other-companies method, and an asset method. They each came up with different value indications and weighted the results differently.

The judge determined that only two methodologies are appropriate to value an interest in this type of business, the cash flow method because it is based on how much cash the partnership will generate through its continued operations, and the asset method because it is based on the value of The LP's assets. The parties stipulated to the value of the timberland property.
The two experts were over $30 million apart in their cash flow methods, partly because of differences in the assumptions that they made in determining what cash flow would be going forward. The disregarded the IRS's experts cash flows as he did not think they were persuasive. This left the judge with The Decedent's cash flow methodology. However, the judge adjusted this value for the following reasons:

1. The cash flows were tax-effected but a pretax rate was used to discount the cash flows, so the judge removed the 25 percent taxes that had been imputed.

2. The discount rate was 18 percent and the judge used 16.25 percent. The expert had used a 3.5 percent specific company risk premium which the judge believed could be eliminated by holding a diversified portfolio of assets. As such, he reduced the specific company risk premium to 1.75 percent. (Note: The IRS's expert's discount rate was 16.22 percent).

After accounting for these adjustments, the indication of value under this method was adjusted to from $33.8 million to $51,702,857.

The judge then addressed the discount for lack of marketability (DLOM). The Decedent's expert used a 35 percent DLOM based primarily on pre-IPO studies, while the IRS's expert used a 25 percent discount based on restricted stock studies. He claimed that the pre-IPO studies tended to overstate the discount. Since the Decedent's expert did not rebut this testimony, the judge selected a DLOM of 25 percent.

The judge briefly discussed the methods that he did not consider appropriate for this valuation. He did not accept the guideline public company method because he did not feel that the companies selected were similar enough. He also put no weight on the other methods as he did not believe they were appropriate and that their values were encompassed by the other methodologies.

The Decedent's expert did not perform an asset method (his asset-accumulation method was similar to an excess earnings method) and the judge relied on the IRS's expert's value for the total net assets. However, the judge did not accept the IRS's expert's discount for lack of control because if the assets were sold, the minority owner would receive a proportionate amount, not a discounted amount of the underlying assets.

The final valuation decision determined was the weighting of the two methodologies. The judge put 75 percent on the cash flow method and 25 percent on the asset method. His reasoning was the there was only a 25 percent likelihood that the assets would be sold because the Decedent would not be able to get enough of the other partners to vote for liquidation of the assets. As a result of the judge's adjustments and reasoning, the value of the Decedent's interest was determined to be $27,454,115.

Despite the difference between the amount claimed on the Decedent's tax return and the amount re-determined by the judge, the judge did not apply a §6662 penalty as the estate relied on a valuation that "was made in good faith and with reasonable cause."

Conclusion:

Based on the evidence submitted, Judge Morrison adjusted the value of the 41.128 percent limited partner interest owned by the estate and determined that a §6662 penalty was not applicable.

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[i] This terminology was used in the case by the judge, not necessarily by the experts.