

TAX COURT CASE UPDATE

Citation:

Estate of Natale B. Giustina v. Commissioner, No. 12-71747 (9th Circuit), December 5, 2014.

Overview:

In an unpublished decision, the Court of Appeals for the Ninth Circuit has reversed and remanded for reconsideration, certain of the Tax Court's findings in the original decision that was reported in T.C. Memo 2011-141.

The Facts:

At the time of his death, Natale Giustina (“the decedent”) owned a 41.128 percent interest in Giustina Land and Timber Company Limited Partnership. The estate reported the value of his interest at \$12,678,117 on the estate’s tax return and the Tax Court determined the value to be \$27,454,115.

The Tax Court decision included several items related to the decedent’s valuation:

1. The cash flows were tax-affected and the judge removed this.
2. The specific company risk premium was divided in half from 3.5 percent to 1.75 percent.
3. The decedent’s discount for lack of marketability was 35 percent, while the IRS’s discount was 25 percent. The court selected the IRS’s discount.
4. The court only applied 25 percent of the weighting on the asset-based approach because it believed that there was only a 25 percent likelihood that the assets would be sold. The remainder of the value was based on the discounted cash flow method (going concern).
5. The court did not apply an underpayment penalty.

Discussion:

On appeal, the Ninth Circuit reviewed the Tax Court’s determinations for “clear error.” It first looked at the weighting of the methodologies that was used to determine the value, and concluded that the Tax Court’s weighting of 25 percent on the asset-based approach was incorrect. The Ninth Circuit stated,

Although the Tax Court recognized that the owner of the limited interest could not unilaterally force liquidation, it concluded that the owner of that interest could form a two-thirds voting bloc with other limited partners to do

so, and assigned a 25% probability to this occurrence. This conclusion is contrary to the evidence in the record. 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.' 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% likelihood to these hypothetical events.

The court went on to state, "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. We therefore remand to the Tax Court to recalculate the value of the Estate based on the partnership's value as a going concern."

With respect to using pretax cash flows, the Ninth Circuit allowed that decision to stand. It stated, "The Estate itself admits in its brief that 'tax-affecting is ... an unsettled matter of law.' We therefore cannot say that the Tax Court clearly erred in adopting a pretax rather than a posttax methodology." The Court also left the discount for lack of marketability alone since the estate's expert had acknowledged that these discounts ranged from 25 to 35 percent.

However, when it came to the specific company risk premium, the Ninth Circuit remanded it for reconsideration because 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."

Conclusion:

The Ninth Circuit reversed and remanded the Tax Court's decision for reconsideration of the likelihood of liquidation and the specific company risk premium.