

KTS, INC.

VALUATION ISSUES™

KLARIS, THOMSON & SCHROEDER, INC.

2012-1

United States Tax Court Case Summary T.C. Memo 2011-141 Estate of Natale B. Giustina, Petitioner Versus Commissioner of Internal Revenue, Respondent Judge Morrison

By: Mr. John A. Thomson, ASA, MAI

The two issues for the Court's decision were (1) the value of the 41.128% Limited Partnership interest in Giustina Land & Timber Co. Limited Partnership owned by Natale Giustina at his death on August 13, 2005. The estate contended the value was \$12,995,000, the IRS contended the value was \$33,515,000, (2) whether the estate is liable for the section 6662 accuracy-related penalty.

Background

Giustina Land & Timber Co. ("GLTC") is a limited partnership located in Eugene, Oregon that owns 47,939 acres of timberland in the surrounding area, which it manages for sustained yield harvesting of timber for purposes of sale on the open market.

GLTC is one of several partnerships which was created from a distribution of substantially all the assets of Giustina Bros. and a distribution of all the assets of Giustina Timber Co., both long standing wood product companies in Lane County, Oregon. The Giustina Bros. Partners, through

ownership in Giustina Bros. Lumber & Plywood, had been involved in the manufacture of wood products. However, in 1988, they closed their last production facility in order to concentrate on the management of their timber base.

Although the brothers operated a number of mills, including sawmills, planing and stud mills, a veneer plant and plywood plant from 1920 to 1990, poor markets and environmental restrictions forced the closure of all operations. The last operating veneer mill was shut down in 1988, such that the assets of the various resulting partnerships of Giustina Bros. and Giustina Timber Co. consisted primarily of timber and timberland in Lane and Douglas Counties, Oregon.

Klaris, Thomson & Schroeder, Inc. ("KTS") (John Thomson) was the expert for the IRS and Willamette Management Associates (Robert Reilly) was the expert for the taxpayer. KTS used a net asset value approach, a guideline companies approach and a discounted cash flow approach. Willamette used an asset accumulation method, more of an income approach (as opposed to a net asset approach), a guideline approach, a capitalization of distributions approach and a discounted cash flow approach. The Court chose to use the net asset approach used by KTS and the discounted cash flow approach used by both experts. The value of the timberlands, which constituted most of the partnership's assets was stipulated at \$142,974,438¹. This value includes a 40% discount for delays related to selling the partnership's, approximately 48,000 acres of timberland (absorption or marketability discount).

The court had problems with both expert's approaches. Essentially, they disregarded three of Willamette's approaches (asset accumulation method, guideline method, and capitalization of distributions method). The court also disregarded KTS's guideline method but accepted its net asset value approach. Relative to the discounted cash flow approach used by both experts, the court had the following comments:

On KTS's discount cash flow approach

(a) The Court did not accept the starting point for projecting future revenues as the last twelve months. They preferred a 5-year average of revenue as the starting or base year.

(b) KTS used a flat operating expense which mirrored the 5-year operating history, however, the Court thought the operating expenses should have increased year-over-year at the same growth of revenues, 3%.

On Willamette's discounted cash flow projection

(a) The Court disagreed with their higher discount rate of 18.0% and terminal capitalization rate of 14.0%. The Court used 16.25% and 12.25% (KTS minority discount rate was 16.22% and cap rate was 12.0%).

(b) **The Court disagreed with Willamette's tax affecting the cash flow stream as it was a pass through entity, essentially stating Willamette used a pre tax return on an after tax cash flow.**

The Court also commented (related to the discounted cash flow approach) that they believed KTS was inconsistent in its

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application of a 20% premium for control in KTS's guideline approach² but only a 12% discount for lack of control on their correlated conclusion. Although KTS believes its logic was correct, KTS recognizes (in hindsight) it was not easy for the Court to accept, as it did give the appearance of being inconsistent.

We point out that the Court accepted KTS's marketability discount of 25% versus Willamette's 35%. It was interesting to note that the Court only applied the marketability discount to the discounted cash flow conclusion and not to the net asset value approach³.

The Valuation Methods that the Court Did Not Adopt

(a) Reilly's (Willamette) Capitalization of Distribution Method

"We did not attribute independent weight to this method for two reasons; first, the cash earned by the partnership is a more reliable indicator of value than the cash distributed to the partners⁴; Second, the capitalization-of-distributions method and the cash flow method share the assumption that the partnership would remain in operation and not liquidate its timberland holdings. In this respect, the methods are duplicated."

(b) Reilly's Asset-Accumulation Method

Reilly first aggregated the distributions that he predicated the partnership would make to the partners' from 2005 until 2040, the end of the term of the partnership agreement. Reilly then discounted these distributions to present value. To this sum, Reilly added the value of the timberlands,

\$143 million, but discounted to present value from the year 2040⁵. The asset accumulation method is effectively a hybrid of the capitalization-of-distributions method and the asset method (net asset value approach). Because the court rejected the capitalization of distributions method and accepted Thomson's net asset value approach, they accorded no weight to Reilly's asset-accumulation method.

(c) Price of stock of similar companies (guideline method)

Reilly chose two publicly traded companies. Thomson chose those two and two additional companies. The court commented, "in our view, neither expert approximately considered that the other companies have assets other than timberland assets and that they earn income from sources other than timber sale. Therefore, we give no weight to the guideline

approach used by Reilly or Thomson."

The following table below shows the comparison of the expert's conclusion and the Court's conclusion. The Court concluded on the second issue, the estate was not liable for a section 6662 accuracy-related penalty. □

¹The gross fair market value of the timberlands before a 40% marketability discount was \$238,290,230, as opined by the taxpayer's forestry expert.

²KTS brought all approaches to the control level before discounting for lack of control and lack of marketability as the net asset value approach was on a control basis as was the income approach. KTS then took a 12% lack of control discount on the correlated conclusion weighted heavily toward the net asset value approach where closed end funds discounts are more applicable for the lack of control discount.

³We believe this had to do with KTS pointing out to the Court that the timberlands had already been discounted 40% for marketability. A moment of high contention in the courtroom.

⁴The Court stated undistributed cash that is used by the partnership to increase the value of the partnership assets increases the value of the limited partner interests.

⁵Essentially turned \$143 million of asset value into

Method and Adjustments	Reilly (Estate Expert)	Thomson (IRS Expert)	Court
Asset-Accumulation Method	10% x \$51,100,000	Not Used	Not Accepted
Cash-flow Method	30% x \$33,800,000	20% x \$65,760,000	75% x \$51,702,857
Capitalization of Distribution Method	30% x \$52,100,000	Not Used	Not Accepted
Price of Shares of Other Companies Method	30% x \$59,100,000	20% x \$99,550,000	Not Accepted
Asset Method (NAV)	Not Used	60% x \$150,680,000	25% x \$150,680,000
Total	\$48,610,000	\$123,470,000	\$76,447,143
Discount for Lack of Marketability	35%	25%	25% (applied to value from cash-flow method only for weighted discount of \$9,694,286)
Discount for Lack of Control	0%	12%	0%
Total After Discounts x 41.128%	\$31,597,000	\$81,490,000	\$66,752,857
	\$12,995,000	\$33,515,000	\$27,454,115

Upcoming Event: LA Chapters "US Court Cases Symposium" on May 17th.

If you have any questions, please contact DeborahAnn Marshall at dmarshall@appraisersla.com



The Los Angeles Chapter of the American Society of Appraisers Presents

U.S. TAX COURT CASES SYMPOSIUM

A MULTI-DISCIPLINE EVENT

In today's uncertain economy, it is essential to have a thorough understanding of the standards, regulatory practices and challenges that are constantly evolving within the industry. At this one-day full event Symposium you will understand how recent U.S. Tax Court case rulings and other key developments affect valuations. Among the valuation issues that will be covered at this Symposium are: Tax-affecting Pass-thru Entities and Proper Application of the Discounted Cash Flow Analysis (DCF), the Guideline Company Approach (Market Approach) in the *Estate of Louise Paxton Gallagher v. Commissioner of Internal Revenue Service*, Partial Interest Discounts in *Andrew K. Ludwick v. Commissioner of Internal Revenue Service*, and Real Estate, Fine Art & Valuation Discounts in the *Estate of James J. Mitchell, Whittier Trust Company v. Commissioner of Internal Revenue Service*. This Symposium features an all-star cast of prominent valuation, legal and tax experts who share their insights and the latest information on recent court rulings that affect current valuation issues.

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U.S. TAX COURT CASES SYMPOSIUM

A MULTI-DISCIPLINE EVENT (CONT.)

Benefits of attending:

“*Inside Scoop*” on what goes on in the court room in US Tax Court

Learn and share knowledge on current issues affecting the industry • Program delivered by leading practitioners

Participate in interactive panel • Network with leading professionals • Earn continuing education credits

Nancy Escher, ASA, ESCHER ASSOCIATES
(Estate's expert in Mitchell)

Carsten Hoffmann, ASA, FMV OPINIONS, INC.
(Estate's expert in Ludwick)

Todd Hollingshead, ASA,
KLARIS, THOMSON & SCHROEDER, INC.

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INTERNAL REVENUE SERVICE

Charles Morris, JD, ALBRECHT & BARNEY

John Prokey, JD, RAMSBACHERPROKEY
(Taxpayer's Counsel in Mitchell)

John Thomson, ASA, MAI
KLARIS, THOMSON & SCHROEDER, INC.
(Estate's Expert in Mitchell, Respondent's Expert in Gallagher)

Dennis Webb, ASA, MAI, PRIMUS VALUATION INC.

Derek W. Kaczmarek,
Senior Attorney at I.R.S. Office of Chief Counsel (2005-2012)

REGISTRATION PROGRAM - THURSDAY, MAY 17, 2012

Pre-registrations must be received by April 15, 2012

On-site registrations are on a space-available basis

PLEASE REGISTER AT [HTTP://WWW.APPRAISERSLA.COM](http://www.appraisersla.com).

IF PAYING WITH A CHECK, COMPLETE THE ONLINE REGISTRATION AND MAIL PAYABLE TO:

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Voice: 818.333.6179 • dmarshall@appraisersla.com • <http://www.appraisersla.com/Events>

CANCELLATION POLICY: For a full refund, cancellations must be made 48 hours prior to event

HOTEL ACCOMMODATIONS RESERVATION METHOD: Standard hotel rates apply, no room block.

Reservations to be made by individual attendees directly with the **SHERATON CERRITOS HOTEL TOWNE CENTER** at (888) 627-7093. All reservations must be accompanied by a first night room deposit or guaranteed with a major credit card. Hotel will not hold any reservation unless secured by one of the above methods.

Thursday, May 17, 2012

Sheraton Cerritos Hotel, 12725 Center Court Drive, Cerritos, California (562)809-1500

SEE AGENDA FOR DETAILS

Registration: 7:30 am to 8:00 am • General AM Session: 8:15 am to 12:15 pm

Lunch: 12:15 pm to 1:30 pm • General PM Session: 1:30 pm to 5:00 pm

Member Cost: \$195.00 Early registration until April 15, 2012 • \$220.00 April 16, 2012 and on-site

Non-Member Cost: \$220.00 Early registration until April 15, 2012 • \$245.00 April 16, 2012 and on-site

Registration Includes: Continental Breakfast, Lunch and materials • Complimentary Self-Parking
Complimentary Wireless Internet Access in Hotel Lobby

CE Approvals:

7 hours O.R.E.A. and MCLE pending* • 8 hours ASA approved *MCLE and O.R.E.A have been submitted for approval.

NEWS & NOTES

Klaris, Thomson & Schroeder, Inc. Happy Birthday!



Mr. John A. Thomson (far left) and his grandson Zane Matthew Graham-Thomson (left adjacent to Mr. John A. Thomson) visiting Kings Point for the Class of 1966 45th Reunion in NY.



From Left to Right; Mr. Tony Abel, Mr. Gary Schroeder, Mr. John A. Thomson celebrating Mr. Ray Klaris' 80th Birthday (sitting down)!

Meet the Newest Valuation Consultants in the St. Louis Area Office

Brian J. Blase. Brian holds a BS from the University of Notre Dame and has attended several appraisal courses and seminars conducted by the American Society of Appraisers and the Institute of Business Appraisers.

Christopher N. Ruedi. Chris holds a BS in Finance from University of Illinois and an M.B.A. from Saint Louis University, John Cook School of Business.

Please join us in welcoming both Brian and Chris to KTS!!



Brian Blase
Valuation Consultant-
St. Louis Office



Chris Ruedi
Valuation Consultant-
St. Louis Office

Upcoming Event; Mr. John A. Thomson, ASA, MAI, Managing Director/VP to speak at the North Orange County CalCPA Interest Group on Thursday, May 24, 2012 at 7:30 a.m. at Marie Calendar's located at 540 N. Euclid, Anaheim, CA 92801.



is a full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.

— Tim Tebow
"I don't have to live the roller coaster other people live with my life. It's hard because people try to have an effect. I try to stay centered in my faith and my family and the close people around me."

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