TIMBER, TRANSFERS, AND TAXES

Grantor Trust Sales with Timberland Family Partnerships

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By John G. Hodnette

Timberland continues to be an attractive alternative investment class for high net worth individuals who are looking for a way to further diversify their investment portfolios beyond equities, bonds, and traditional real estate. The Fall 2017 KPMG, LLP *Timberland Investor Sentiment Survey* suggests that timberland may rise in value in the coming years, as American housing climbs back to all-time highs and China's trend towards banning its commercial logging potentially drives international demand for timber. The *Hancock Timberland Investor* February 2019 newsletter analyzed US private timberland's investment performance in 2018. The National Council of Real Estate Investment Fiduciaries Timberland Property Index (TPI) reported a total return of 3.2 percent for calendar year 2018. The TPI is based on 453 timberland properties across 12.5 million acres within the United States with a combined market value of $23.1 billion. This 3.2 percent return was an improvement from 2017's 2.8 percent and the highest annual income return reported for US timberland since 2006's 4.6 percent. The TPI is made up of both capital appreciation of the timberland itself and the operating income. But 2018's 3.2 percent was almost entirely based on increases in operating income. Almost two-thirds of the TPI is made up of southern US timberland.

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Timberland is an asset with a uniquely long-time horizon, with growing periods of 25 to 40 years from seedling to mature timber, using the loblolly pine as an example. This long growth period together with the US Tax Court's recent favorable treatment of valuation discounts (particularly in the *Giustina* case discussed below) makes timberland a prime asset for tax-advantaged estate planning using family limited liability companies and family grantor trusts.

Grantor trusts have grown in the last 30 years to become an essential component of the modern estate planner's repertoire. These unique trusts, which are disregarded for income tax purposes as separate from their owners, can be particularly effective when used in conjunction with family limited liability companies taxed as partnerships to transfer assets out of the estate of the grantor. These transfers are accomplished via the use of grantor trust installment sales.

Because of grantor trusts' unique tax treatment, sales between grantors and their grantor trusts are completely disregarded for income tax purposes. This is because, for income tax purposes, the assets owned by a grantor trust are treated as being owned directly by the grantor. A sale between a grantor and his grantor trust is as nonsensical, for income tax purposes, as an individual's left pocket purchasing that individual's wallet from his right pocket. In contrast, a sale to a grantor trust *is* respected under the separate transfer tax regime.

Estate planners have thus found that the sale of assets to a grantor trust can be very useful as a transfer tax "freeze" technique, moving highly appreciating assets out of a grantor's estate in exchange for a promissory note in the amount of the property's appraised value at that time. In the period between this transfer and the grantor's death, transferred assets will have time to grow exponentially, in addition to potentially providing cash flow to the grantor trust to be used to make payments on the promissory note. When the grantor dies, the promissory note (which was theretofore ignored for income tax purposes) springs into existence as the grantor trust becomes non-grantor. The trust then pays off the note to the estate of the grantor, if it has not already done so. Provided that the asset appreciates, as expected, the growth of the asset within the trust outstrips the interest payments associated with the promissory note and thus effectively moves value outside of the estate of the grantor.

Grantor trust installment sales, as briefly explained above, are commonly used to transfer minority interests in closely held family businesses from the grantor to the

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Even with precautions and particularly in the absence of them, the time between plantings and realization of income can be very long.

grantor trust. These minority interests in closely held businesses commonly receive valuation discounts for lack of marketability and lack of control in the qualified appraisal commissioned to determine the fair market value of the interest. Valuation discounts arguably increase the effectiveness of a "freeze" transaction grantor trust installment sale by reducing the fair market value that the grantor must receive in exchange for the transfer of the assets.

Timberland's growing period adds another level of complexity in valuing timberland property. As noted above, timber can take between 25 to 40 years to grow. Most owners of timberland handle these long growing periods by dividing timberland into separate acres with different planting years so that harvesting income is more regular. For example, an owner of timberland may plant loblolly pines every ten years so that, at time of harvest, one-fourth of the acreage of the timberland is ten years old, one-fourth is 20 years old, one-fourth is 30 years old, and the oldest one-fourth is 40 years old and ready for harvest. This division of the acreage into different age growths allows for more regular flows of income and also helps to hedge the risk against bad growing seasons or pests completely destroying timberland crop. Even with these precautions, however, and particularly in the absence of them, the time between plantings and realization of income can be very long. This makes these assets particularly ideal as the subject of grantor trust sale "freeze" techniques. The value and success of a newly-planted acre of loblolly pines 40 years in the future can be very difficult to determine. That acre could be ravaged by storms, infested with pine beetles, or become stunted by a period of drought. Or it could grow to be one of the healthiest, tallest, and straightest acres of trees in that growing season—destined to become the region's generation of high quality telephone poles. The only certainty is uncertainty. Therefore, a grantor who finds herself within 40 years of her life expectancy may do very well by betting on that acre of pine seedlings and selling it to her grantor trust after a qualified appraisal. She would do even better to transfer a minority interest in a limited liability company that owns that particular timberland.

US courts have addressed valuation of minority interests in timberland multiple times. In *Estate of Giustina v. Commissioner*, T.C. Memo. 2016-114 (2016), for example, the Tax Court and Ninth Circuit addressed how timberland should be valued and what discounts were appropriate for a 41 percent limited partnership interest in a partnership owning 47,939 acres of timberland. Id. at *3. The Tax Court in the first opinion, *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141 (2011), weighed the testimony of two valuation experts who testified as to how best to value timberland. The two methods considered by the court were the cashflow method and the asset method. The cashflow method treated the timberland partnership as a going concern and based value on "how much cash the partnership would be expected to earn if it had continued its ongoing forestry operations . . . which consisted of growing trees, cutting them down, and selling the logs . . . ." Id. at *5. The asset method, in contrast, is based on the value of the partnership's assets if they were sold. Id. The partnership's total asset value in the *Giustina* case was determined to be $150,680,000, $143 million of which was the asset value of the timberland itself. Id. at *9. This asset value includes a 40 percent discount for expected delays in selling the assets. Id. The Tax Court in the first opinion determined that, because there was a 25 percent chance that the partnership might liquidate, 25 percent of the valuation should be based on the asset method and 75 percent should be based on the cashflow method. This resulted in a total valuation of $27,454,115 for the 41 percent partnership interest, applying a 25 percent discount for lack of marketability on 75 percent of the valuation. Id. at *9.

The estate appealed the Tax Court's decision to the Ninth Circuit Court of Appeals, which ruled that the Tax Court's determination that there was a 25 percent likelihood of future liquidation of the partnership was "contrary to the evidence in the record." *Estate of Giustina v. Commissioner*, 586 Fed. App'x. 417, 418 (9th Cir. 2014). Therefore, the Ninth Circuit ordered the Tax Court to "recalculate the value of the Estate based on the partnership's value as a going concern." Id. In addition, the Ninth Circuit reversed one of the Tax Court's minor adjustments to valuation regarding a risk premium. Id. at 419. As a result, the case was remanded back to the Tax Court, which, in *Estate of Giustina v. Commissioner*, T.C. Memo. 2016-114 (2016), recalculated the value of the 41 percent interest completely by the going concern cashflow method, cutting the value in half from the $27,455,115 value of the first Tax Court opinion to the final value of $13,954,730. Id. at *1, *17-18.

The *Giustina* case's decision to value the timberland partnership based only on its cashflow is instrumental in its very deep discounts. A valuation based solely on the asset method, for contrast, would have resulted in a value of $62,423,710 for the 41 percent interest. The Commissioner has since attempted to convince courts to go against this aspect of the case and consider the asset value of timberland partnerships in addition to their more conservative cashflow value.

The courts have also applied discounts

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in the context of the transfer of timberland by gift. In *Williams v. Commissioner*, T.C. Memo. 1998-59 (1998), for example, the court concluded that a discount of 44 percent was reasonable for an undivided one-half interest in two parcels of timberland. This discount was calculated as a 30 percent discount for lack of control, followed by a 20 percent discount because of lack of marketability, for a total of 44 percent.

Taking all of this together, clients with timberland might be able to consolidate their timber business and provide for their estate planning and estate tax needs through the use of limited liability companies and grantor trust installment sales. The resulting transfers not only reduce the taxable estate of the grantor but also allow for potential exponential growth of timberland profits to be realized by the next generation in the most tax-efficient manner. The use of limited liability companies also provides a mechanism and structure for decision making and dispute resolution for the family business. Such a structure is crucial when control shifts to the next generation of family members, who may not always see eye-to-eye. Moreover, these important business purposes should satisfy the bona fide business arrangement and legitimate and significant nontax purpose requirements of IRC §§ 2703(b)(1) and 2036(a). Because timberland requires a good deal of management action and organization, it is not too difficult to show why the use of a limited liability company has a plethora of business benefits.

Let's see how timberland estate planning could look with a simple hypothetical. Say a client owns four acres of loblolly pine timberland with a total value of $7,600. This timberland is divided, as in the manner discussed above, into four one-acre sections of varying ages, one acre with 10 year old pines, one acre with 20 year old pines, one acre with 30 year old pines, and the final acre with 40 year old pines. Because of the varying ages of the pines, each acre has a very different value. The 10 year old acre is valued at only $100, the 20 year old acre is valued at $1,000, the 30 year old acre is valued at $2,500, and the final 40 year old acre is valued at $4,000. All such valuations consider the length of time before any cashflow can be expected from these acres and the risk that these acres may never produce market value timber.

Your client, Grantor, realizes that he will not likely live to see the 10 year old acre grow to full maturity and he wants his grandchildren to benefit from and perhaps become active in the family timberland business when he is gone, so he decides to form a limited liability company called Timberland, LLC and contribute the 10 year old acre into Timberland, LLC. Grantor then proceeds to sell a 40 percent interest in Timberland, LLC to a grantor trust he had created previously for the benefit of his grandchildren. Grantor properly obtains a qualified appraisal that determines that the 40 percent interest in Timberland, LLC has a value not of $40 (40 percent of the $100 acre) but of $22.40 (40 percent of the $100 acre subject to a 30 percent discount for lack of control followed by a 20 percent discount for lack of marketability, or a total discount of 44 percent). Therefore, Grantor's grantor trust purchases this 40 percent interest in Timberland, LLC in exchange for a promissory note for $22.40 and the proper rate of interest.

Thirty years go by, and Grantor passes away. Grantor's grantor trust becomes a non-grantor trust at Grantor's death. The loblolly pines that were 10 years old at the time of the formation of Timberland, LLC have now grown at year 40 to an impressive height and quality. They are now worth $4,000 for the entire acre and are cut down and sold for that price. As a 40 percent member, the grantor trust receives a distribution of $1,600. If it has not already done so, the trust pays off the $22.40 promissory note plus all accrued interest to the estate of Grantor. The trust now is able to sprinkle income to Grantor's grandchildren, who are the beneficiaries of the trust. The value of the grandchildren's interest in that 40 percent of the acre has grown over 71 times in that 30 year period (or an annualized compounding return of about 15.29 percent), and all of this growth was outside the taxable estate of Grantor.

Estate planners should consider techniques such as the one briefly summarized in this article to maximize the transfer tax savings of their high net worth clients, yet also providing for a streamlined mechanism for their client's heirs to take part in their timberland business. As the US housing markets trend toward returning to their 2006 highs, there may be no better time to engage in estate planning with this unique asset class. ■

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