If a Tree Falls in the Woods, is the Business a "Going Concern"?

Giustina Decision Reversed and Remanded for Recalculation by Ninth Circuit

According to the Ninth Circuit, the answer to the question above is "Absolutely." This case involved a limited partnership owning timberlands that was formed 15 years prior to Mr. Natale B. Giustina's death. After the family's lumber mills were sold, timberlands owned for decades within the family's business entities were transferred to a new partnership in order to effect a family ownership and management restructuring. The timberlands continued to be held and managed by the partnership and there was no desire or intention to liquidate these assets at the time of Mr. Giustina's death. In Tax Court, Judge Morrison opined that 25% weight ought to be given to the liquidation value of the partnership, and 75% weight ought to be given to its going concern value, which was determined through a capitalization of cash flow method.

In a brief but acerbically written decision, the Ninth Circuit concluded that Giustina Land & Timber Co. Limited Partnership must be treated as a going concern when valuing a 41.128% limited partnership interest, as there was no indication of any desire by the general partner to liquidate assets. The Ninth Circuit stated, "As in …Simplot …(Ninth Circuit, 2001), 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."

Background

In June 2011, the Tax Court rendered its opinion as to the fair market value of a 41.128% limited partner interest in Giustina Land & Timber Co. Limited Partnership includable in the Estate based on a preponderance of the evidence. The partnership was formed in 1990 and governed by a written

partnership agreement that clearly gave the general partners full control over the business of the partnership. A general partner could be removed by the concurrence of limited partners owning two-thirds of the interests in the partnership. Limited partners were not permitted to withdraw from the partnership, and were not allowed to transfer their interests without the consent of the general partners, unless such transfer was to another limited partner or a trust for the benefit of a limited partner. A buy-sell agreement was also effective, which limited transfers to certain family members and provided rights of first refusal on any other transfers. The partnership was to continue until December 2040 and there was no indication that the Giustina family would do anything but continue to operate the partnership's timber business as it had for decades.

In Tax Court, the IRS called expert witness John Thomson of Klaris, Thomson & Schroeder, Inc., to opine on the value of the Estate's interest, while the Estate called expert witness Robert Reilly of Willamette Management Associates. The following table summarizes the methods, calculations and conclusions of the experts and the Tax Court:

Giustina Tax Court Case - Valuation Comparison
($000)

Method/Adjustment	Estate (Reilly)	Weight	IRS (Thomson)	Weight	Tax Court (Judge Morrison)	Weight
Asset Accumulation Method	51,100	10%	NA	0%	NA	0%
Cash Flow ("CF") Method	33,800	30%	65,760	20%	51,703	75%
Capitalization of Distributions Method	52,100	30%	NA	0%	NA	0%
Guideline Company Method	59,100	30%	99,550	20%	NA	0%
Asset (Liquidation) Method	NA	0%	150,680	60%	150,680	25%
Weighted Value	48,610		123,470		76,447	
Discount-Lack of Control (DLOC)	0.0%		12.0%		0.0%	
Discount-Lack of Marketability (DLOM)	35.0%		25.0%		25.0% (DLOM applied to CF method only)	
Total Fair Market Value	31,597		81,490		66,753	
FMV of 41.128% LP Interest	**12,995**		**33,515**		**27,454**	

We made the following observations in reading the Tax Court case, among others:

- Judge Morrison took issue with parts of both experts' methods;
- Judge Morrison did not accept Reilly's reduction to cash flow of 25% for taxes, stating that the reduction "is inappropriate because the rate at which Reilly discounted the cash flows to present value was a pretax rate of return…" Since Reilly built up to a discount rate by using rates of

return on publicly traded companies, virtually all of which are taxable, Judge Morrison's view is curious.

- Thomson's analyses were "not persuasive," in large part due to internal inconsistencies and unrealistic cash flow assumptions.
- Reilly opined that a DLOM of 35% was appropriate based on restricted stock and pre-IPO studies. Thomson concluded that a 25% DLOM was warranted based on his review of restricted stock studies. In an odd twist, Reilly testified that 25% was "also reasonable." Even more puzzling was that Thomson relied successfully on an SEC Study that is now more than 40 years old. Thomson argued that pre-IPO studies tend to overstate discounts. Because Reilly did not refute this statement, the court accepted 25%.
- The Tax Court disagreed with Thomson's placement of greater weight on the asset (liquidation) method, and concluded that 75% weight should be applied to the going concern (cash flow method) value, and 25% to the value from the asset (liquidation) method. Despite this seemingly favorable stance, other adjustments led the Court to conclude a fair market value for the Estate's interest more than double what was reported on the federal estate tax return.
- No IRC Section 6662 penalty for underpayment of tax was levied, as it was determined that the Estate acted in good faith.

Ninth Circuit Decision

On December 5, 2014, the U.S. Court of Appeals for the Ninth Circuit issued a ruling reversing the decision of the Tax Court and remanding for recalculation. The Ninth Circuit reviewed the Tax Court's decision for "clear error," and found that the Tax Court clearly erred in two instances. First, the application of 25% weight to the asset (liquidation) approach was found to be "in contrary to the evidence in the record." The Tax Court's logic that minority interest owners could get together and form a two-thirds voting block was an example of engaging in "imaginary scenarios," a clear error reminding us all of the important Simplot case (2001). Second, the Tax Court clearly erred by failing to adequately explain its basis for cutting in half the Estate expert's proffered company-specific risk premium, stating that "the Tax Court is obligated to detail its reasoning." We also note that the Ninth Circuit reviewed the Tax Court's elimination of tax affecting of the cash flows (applied by Reilly), but because the Estate admitted that this issue is "an unsettled matter of law," the Ninth Circuit could not say that the Tax Court clearly erred on this point.

MPI Commentary:

The taxpayer scored a key victory with the Ninth Circuit's decision. We will now wait to see the revised and final determination of the Tax Court. The Ninth Circuit's decision was important and appropriate, as it is entirely consistent with the concept that a limited partner in a partnership has no ability to control the entity or obtain access to its underlying assets. Placing weight on the liquidation value of the partnership would ignore such facts and likely overvalue the limited partnership interest by a significant margin. This is not to say that the value of underlying assets is irrelevant. Rather, the focus should be on cash flow, and consideration ought to be given to the discounted NAV method, a widely accepted method where discounts for lack of control and lack of marketability are derived from capital markets and applied to NAV (liquidation value).

It is also important to point out that the Ninth Circuit gave important consideration to the hypothetical willing buyer / willing seller standard. The Ninth Circuit found that the Tax Court's decision is in violation of this standard when it develops imaginary scenarios involving partners getting together and removing the general partner or pursuing liquidation.

The implications of this case remain to be seen. Nonetheless, this decision re-opens the door for a long-held argument that a minority interest in a minimally profitable, closely held real estate company, where liquidation is either not practical or simply not on the horizon, may be worth a fraction of its pro-rata share of net asset value.

Getting back to the original question at hand, in the case of Giustina, if a tree falls in the woods due to ongoing timber operations, and you are valuing a minority interest, the entity ought to be treated as a "going concern."

More Information

For more information or specific questions on this case, please contact the author, whose contact information follows:

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