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Takeaways from the *Pierce* Case

The Importance of Relevant Data and Reasoned Analysis

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The recent U.S. Tax Court opinion in ***Kaleb J. Pierce v. Commissioner of Internal Revenue*** (T.C. Memo 2025-29) offers insight on several issues that regularly feature in the valuations of privately held business interests. By presenting an issue-by-issue analysis, the *Pierce* decision reinforces an important message for appraisers and estate planners: relevant data and reasoned analysis carry the day in court.

Background

The subject company, Mothers Lounge, LLC, an S corporation for tax purposes, sold mother and baby products. The company sold cheaply manufactured goods directly to consumers. The business relied on a "free, just pay shipping" no returns model, which afforded it a high profit margin, but came with a plethora of unsavory business practices, including copying competitor products, over-charging customers for shipping, undermining wholesalers and marketing affiliates, and suppressing customer reviews.

The business history and practices detailed in the Findings of Fact are sufficient to raise eyebrows in a room full of former FTX executives. The dubious business model invited frequent litigation, with most lawsuits filed for trademark infringement. Two lawsuits were specifically described, one of which was for patent infringement and illegal marketing practices that had "ballooned into an existential threat." Adding to these murky undercurrents were an affair of one of the business principals and a blackmail demand letter that spurred an FBI investigation. As noted by the Tax Court, these developments had "caused extreme dysfunction with the company's management and demoralized the workforce" in the timeframe before the valuation date.

The company's business practices may have raised eyebrows, but they were lucrative. The first successful product, a nursing cover, illustrates the model. (see Figure 1)

Figure 1

Product Price	$0.00
Shipping & Handling Fee	7.95
Revenue Per Unit	$7.95
Less: Manufacturing Costs	(1.30)
Less: Shipping Costs	(1.57)
Contribution Per Unit	$5.08
Contribution Margin	*64%*

Despite giving the product to customers for “free,” Mothers Lounge, LLC earned a healthy 64% contribution margin on each unit sold, which was more than sufficient to cover all other operating expenses of the business. In 2013, the company had an EBITDA (earnings before interest, taxes, depreciation and amortization) margin of 29%, which many readers will recognize as above average for a consumer products business. The company was debt-free and required minimal investments in depreciating assets, making EBITDA a good proxy for pre-tax cash flow.

The *Pierce* court had to decide the proper value for gift tax purposes of two minority interests in Mothers Lounge, LLC that were transferred in 2014 (a 29.4% interest and a 20.6% interest).

Expert Witnesses

The taxpayer’s expert prepared a valuation report submitted at trial. During the administrative appeal of the case in 2017, the taxpayer’s expert had also prepared a forecast for the business (the “2017 Forecast”). The taxpayer’s expert did not rely on the 2017 Forecast in his appraisal of the subject interests before the Tax Court, but the valuation expert for the IRS did. To recap, there were two valuation experts at trial, one for the taxpayer and one for the IRS. In preparing his appraisal, the IRS's valuation expert relied on the 2017 Forecast prepared by the taxpayer's expert, but the taxpayer's expert did not rely on the 2017 Forecast in preparing his appraisal.

Key Issues

Forecast

While both experts agreed on the application of the income approach, they relied on different forecasts. The forecast prepared by the taxpayer's expert for his appraisal report relied on an analysis and assessment of relevant factors and market trends "known or knowable" as of the valuation date, which the Court deemed credible. In contrast, the IRS's valuation expert relied on the 2017 Forecast "without independent verification," which the Court easily rejected.

The fact that the taxpayer's expert prepared the forecasts underlying both his own report and that of the IRS's valuation expert is a unique feature of the case. While the *Pierce* court deemed the forecast used by the taxpayer's expert credible, it declined to ascribe weight to the 2017 Forecast used by the IRS's valuation expert (which was prepared by the taxpayer's expert). According to the opinion, the taxpayer's expert "was in a time crunch" to prepare the 2017 Forecast and he ultimately relied on post-valuation data to support its projections. The Court noted that the 2017 Forecast lacked any analysis or discussion of the events surrounding the FBI investigation and inappropriately relied on post-valuation data. The Court pointedly stated that "this reliance blurs the line between information that was known or knowable as of the valuation date and the information that was not reasonably foreseeable as of the valuation date."

Tax Affecting

Both experts agreed that tax affecting the earnings of the company (an S corporation) was appropriate and used the Delaware Chancery method to calculate substantially equivalent tax rates (26.2% and 25.8%).

The Court commented that tax affecting earnings of tax pass-through entities can be rejected where "a party fails to adequately explain" its necessity or where the experts "have not accounted for the benefits of S corporation status to shareholders." We note that the 2017 *Tax Cuts and Jobs Act* brought C and S corporations closer to parity in taxation, diminishing the additional economic benefits formerly realized by owners of pass-through entities. Nonetheless, the *Pierce* opinion affirms that the valuation of an interest in a tax pass-through entity should account for the effect, if any, of tax status on the value of the interest.

Discount Rate

Mothers Lounge, LLC had no debt and both experts developed a cost of equity capital (COEC) discount rate using the build-up method. The key differences between the experts were in the presentation of the underlying data and the application of a company-specific risk premium (CSRP).

The taxpayer's expert used the Kroll Cost of Capital Navigator platform, which includes tables with output results, but does not present the underlying data. In contrast, the IRS's valuation expert "provided a thorough review of his process and the academic papers that supported his equations." Citing the lack of supporting data in the taxpayer's expert report, the Court accepted the COEC rate concluded by the IRS's valuation expert.

Of particular interest is the issue of company-specific risk premium. The taxpayer's expert added a CSRP of 5% to the build-up analysis, while the IRS's valuation expert applied a 0% premium. In discussing the company-specific risk premium, the Court acknowledged that the build-up method allows for the consideration of such risks, but expressed concern that such risk factors may already be accounted for in other elements of the build-up approach (such as the size premium). Ultimately, the Court did not accept the premium applied by the taxpayer's expert, who had cited five risk factors he considered in arriving at his conclusion for the premium. The Court chided the taxpayer's expert for failing to provide sufficient details to allow the Court to understand the derivation of the selected premium. The Court's conclusion confirms the need to support the application of a company-specific risk premiums with reference to available market evidence and the overall reasonableness of the resulting conclusion of value.

Applicable Discounts

Both experts applied discounts for lack of control and lack of marketability in the valuation of the subject minority interests.

- With respect to the discount for lack of control, the experts differed in the approach used to determine the discount and its application. The Court adopted the taxpayer's expert 5% discount which was based on analysis of the company's operating agreement, capital market evidence, and consideration of relevant facts and circumstances. In contrast, the IRS's valuation expert applied a 10% discount, but only to the non-operating assets of the business. In its rejection of the latter approach, the Court once again cited the lack of underlying supporting data and analysis.

- The experts applied similar (25% and 30%) discounts for lack of marketability supported by detailed explanations of their methodologies and conclusions. The Court found the methodology used by the taxpayer's expert to be "slightly more persuasive." The Court once more expressed concern that the IRS valuation expert relied on the 2017 Forecast. Of note, the Court's finding in favor of the (lower) marketability discount proffered by taxpayer's expert was actually adverse to the taxpayer's overall position.

Conclusion

The material valuation issues in the *Pierce* case include the proper data to use in preparing a forecast, tax affecting pass-through earnings, and supporting appropriate risk factors and discounts to be applied in the valuation of closely held business interests. The Court's consideration of each issue underscores the importance of marshalling relevant data and presenting reasoned analysis in valuation reports.

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