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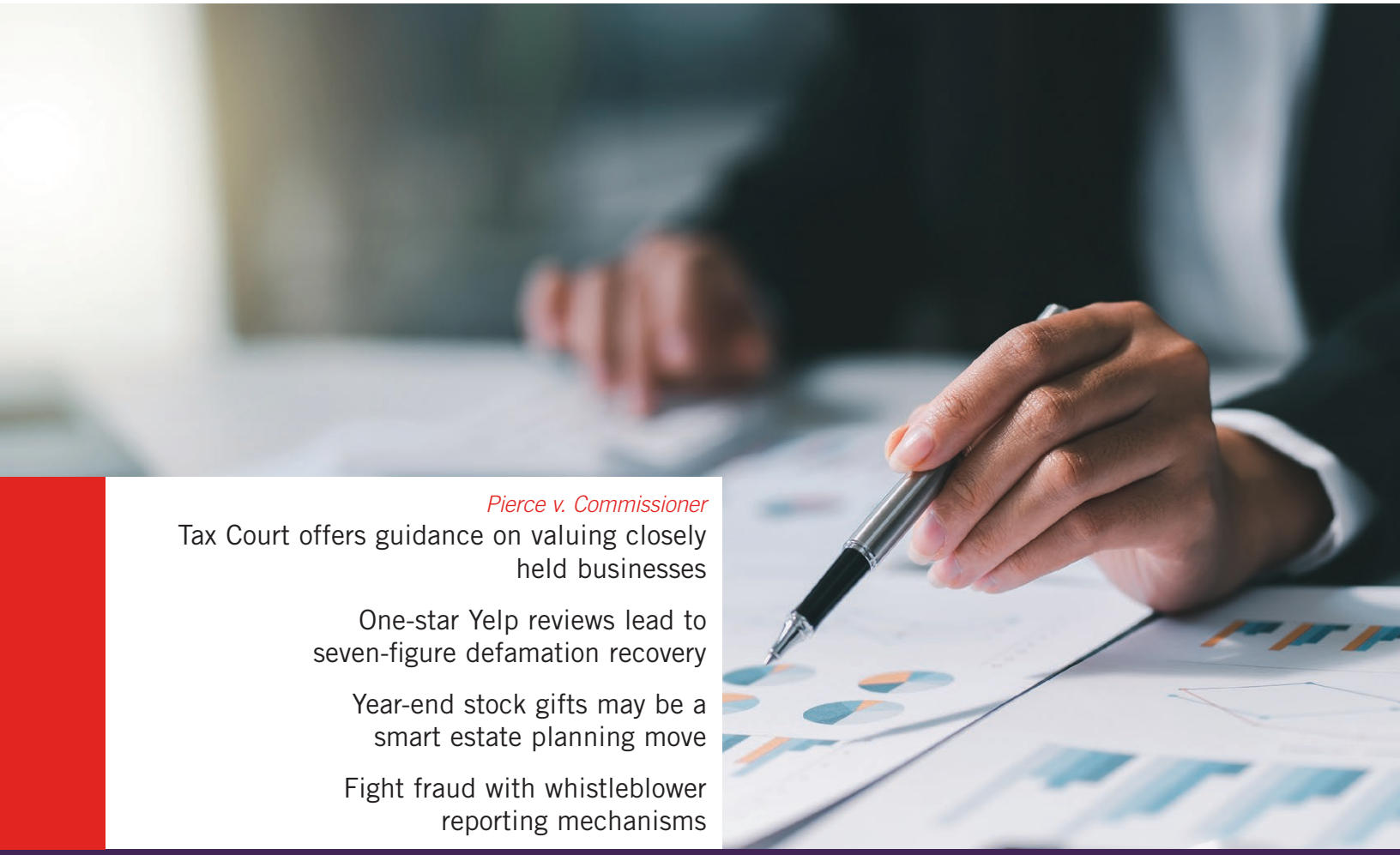

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*Pierce v. Commissioner*

# Tax Court offers guidance on valuing closely held businesses

The U.S. Tax Court recently provided guidance on valuing closely held business interests for federal gift tax purposes. The IRS challenged the taxpayers' reported values, leading to a dispute over the nuances of determining the fair market value of noncontrolling, nonmarketable business interests.

## Background

In *Pierce*, a married couple owned an S corporation that specialized in maternity and baby products. In June 2014, each spouse gifted 29.4% of the company's stock to an irrevocable trust. Then each sold his or her remaining shares to an entity that the trust owned for a $3.4 million note. On their federal gift tax returns, the 29.4% business interests were valued at approximately $4.9 million each based on a September 2014 valuation report. The couple didn't report the sold interests on their returns, claiming that their values equaled the outstanding principal on the notes.

The IRS alleged that the transferred interests were undervalued, assessing nearly $7 million in tax deficiencies and penalties. The taxpayers responded by submitting a second valuation report in 2017 that forecast the company's revenue based on historical data and the original valuation report.

## Tax Court proceedings

At trial, the parties' experts agreed that the discounted cash flow (DCF) method under the income approach was appropriate for valuing the transferred interests. The taxpayers' expert, who had prepared both valuation reports, estimated that the company was worth roughly $18.7 million on a controlling, marketable basis. After applying a 5% discount for lack of control (DLOC) and a 25% discount for lack of marketability (DLOM), he arrived

at approximate values of $3.9 million per gift and $2.7 million for each sale.

Based on projections from the opposing expert's 2017 report, the IRS's expert valued the entire company at approximately $28.1 million. He applied a 10% DLOC to only the company's nonoperating assets, followed by a 30% DLOM to the company's preliminary value estimate. His final value conclusions were $5.8 million per gift and $4.1 million for each sale.

## Tax Court decision

The Tax Court ultimately sided with the taxpayers on most valuation-related issues, including:

**Forecasts.** The court found that the taxpayers' expert offered the clearest revenue forecast as of the valuation date. Relying on data from the online baby product industry, he forecast that sales would decline to the industry's growth rate through 2017 and gradually stabilize to a 3% long-term growth rate.

Although the IRS challenged the expert's reliance on events after the valuation date, the court found that these subsequent events were reasonably known or knowable. For example, the industry was known to have high profit margins and exceptionally

### To tax affect — or not?

When using the income approach to value S corporations and other pass-through entities, business valuation professionals often "tax affect" forecasted earnings. That is, they apply an assumed corporate income tax rate to the company's earnings. The purpose is to reflect 1) the taxes owners pay on their shares of the company's profits, and 2) the risk that the entity could subsequently convert to a C corporation, making it subject to entity-level taxes.

In recent years, the U.S. Tax Court has applied tax affecting narrowly, rejecting it unless the record clearly shows its necessity. Also, the court rejects tax affecting when experts fail to account for the avoidance of entity-level taxes, the key benefit of S corporation status. Under one common tax-affecting method — the Delaware Chancery method — valuators apply a reduced hypothetical tax rate to account for the tax burden on owners of pass-through entities while also reflecting that status's tax benefits.

low barriers to entry, making increased competition likely. Moreover, the company wasn't developing new products. The court rejected the IRS expert's forecasts because he relied on the 2017 valuation report without testing or independently verifying the underlying data or assumptions.

**Discounts.** The court accepted the taxpayers' expert's valuation discounts, finding them to be more reasonable than the IRS expert's discounts. It concluded that the IRS's expert's 10% DLOC was unsupported and improperly restricted to nonoperating assets. The taxpayers' expert applied his DLOC to the company's total value and based it on a control premium study.

> Both experts agreed that a hypothetical buyer and seller would have considered the company's S corporation status.

Regarding marketability, the taxpayers' expert reviewed pre-initial public offering and restricted stock studies and adjusted his DLOM using factors from *Mandelbaum* (T.C. Memo 1995-255). The IRS's expert used the option pricing model and reviewed restricted stock studies. The court found the taxpayers' expert's DLOM analysis to be "slightly more persuasive," noting that his estimates were based on companies similar to the subject company.

**Tax affecting.** Both experts agreed that a hypothetical buyer and seller would have considered the company's S corporation status. Accordingly, the experts tax affected their revenue forecasts, applying hypothetical tax rates based on the Delaware Chancery method. (See "To tax affect — or not?" above.)

The court agreed that tax affecting was appropriate. It found that the 26.2% rate used by the taxpayers' expert was better supported than the rate used by the IRS's expert (25.8%). Note that the stock transfers in *Pierce* took place before the Tax Cuts and Jobs Act permanently cut corporate income tax rates, so it's possible that the model would produce different results today.

## Business valuation primer

Valuing closely held business interests is complex. *Pierce* provides guidance on several potentially contentious issues. In addition to the above, the court discussed calculating the discount rate for determining present value, measuring a company's terminal value under the DCF method and adjusting for nonoperating assets. The case underscores the importance of hiring an experienced business valuation professional to handle such complexities and provide detailed support for the underlying assumptions and analyses. ■

# One-star Yelp reviews lead to seven-figure defamation recovery

Online and social media reviews can make or break a business. But *false* claims can lead to costly damages against the person who posts them. The defendant in a recent defamation case — *Creal v. Nasiri* — learned this lesson when she posted a false Yelp review for a CPA retained by her husband to be an expert witness in the couple's divorce. The California Court of Appeal recently affirmed a $1.6 million damages award to the CPA.

## Bad review backfires

After serving as the husband's financial expert, the CPA in question filed an amended tax return for him, switching his filing status to married filing separately. Although the return claimed half of a tax credit for a previous tax year, the IRS mistakenly refunded the full amount to the husband.

The wife responded by posting a one-star review on the CPA's Yelp page, falsely claiming that he'd:

- Manipulated her tax return to obtain the full refund for the husband, and
- Engaged in various acts of fraud, conspiracy, harassment and stalking.

She also implied that the CPA was a convicted felon and made several similar posts in the following months. He subsequently sued the wife for defamation.

> Proving lost profits requires only reasonable certainty, not mathematical precision.

## Double experts, double trouble

At trial, the CPA hired two expert witnesses. First, a financial forensics expert examined the CPA firm's tax returns and found that it had grown at an average annual rate of 11.7% for the five years before the wife's negative reviews. It grew only 0.3% in the two years after her reviews. The expert's damages analysis considered various factors, such as the strength of the economy, accounting industry growth benchmarks, firm-specific characteristics, client retention rates and variable cost savings from the lost business. She concluded that the wife's posts had caused the firm's growth to stall.


The second expert, an online reputation specialist, testified that Yelp reviews generally appear at the top of search results. So the wife's negative posts were visible to everyone who searched for the CPA online. He opined that her negative reviews caused the CPA's business to decline, as evidenced by an increasing number of individuals searching for

his name after the wife's posts, combined with the decline in the firm's growth.

## Experts tip the scales of justice

The trial court awarded the CPA nearly $1.6 million in damages, including approximately $1.3 million in lost profits, based on his experts' testimony. The wife appealed, arguing, among other things, that the lost profits were speculative. The appellate court disagreed, finding that the damages analysis was supported by substantial evidence and wasn't unduly speculative. It noted that proving lost profits requires only reasonable certainty, not mathematical precision. The court ruled that the CPA offered ample evidence to support his claim.

Additionally, the wife argued there was no substantial evidence that her conduct proximately caused the CPA's lost profits. She cited the absence of evidence that any specific individual saw her posts. Further, she claimed the effects of her review couldn't be distinguished from other contributing factors, such as economic trends, changes in the law, the demand for expert testimony and new employees. But the appellate court found sufficient circumstantial evidence that the posts were viewed and negatively affected the CPA's business. Plus, the CPA presented reliable evidence that external factors weren't responsible for the firm's stalled growth.

## Lessons learned

This case demonstrates the importance of using qualified experts and solid data to support lost profits and economic damages claims. It also provides a valuable reminder that negative online reviews can backfire if you can't back them up. ■

# Year-end stock gifts may be a smart estate planning move

In July 2025, Congress passed sweeping legislation known as the One, Big, Beautiful Bill Act (OBBBA), which makes the expanded lifetime gift and estate tax exemption permanent. Here's how the new tax rules, combined with current market conditions, may create estate planning opportunities for closely held business owners.

## Lifetime exemption

The Tax Cuts and Jobs Act (TCJA) almost doubled the federal lifetime gift and estate tax exemption, starting in 2018. For 2025, the inflation-adjusted lifetime exemption is $13.99 million (effectively $27.98 million for married couples). The expanded lifetime exemption was scheduled to return to the pre-TCJA limit for 2026 and beyond. However, the OBBBA permanently extends it. For 2026, the lifetime exemption will be $15 million (effectively $30 million for married couples). It will continue to be adjusted annually for inflation.

If a taxpayer makes cumulative lifetime taxable gifts above the exemption amount, the excess is taxed at a flat 40% rate. If a taxpayer passes away with an estate valued at more than the exemption amount less any gift tax exemption used during life, the excess is taxed at the same flat 40% rate. (Note: Some states also impose inheritance or death taxes, and the exemptions may be much lower than the federal exemption.)

## Gift tax annual exclusion

Taxpayers can exclude gifts up to the annual exclusion amount — twice that per recipient if

spouses elect to split a gift or give community property — without using up any of the lifetime gift and estate tax exemption. Gifts that don't exceed the annual exclusion don't count toward the lifetime exemption. For 2025, the annual exclusion is $19,000 per recipient ($38,000 for married couples making a gift together).

This is a use-it-or-lose-it proposition. Taxpayers must use the annual exclusion each year by December 31. It doesn't carry over from year to year.

## Benefits of stock gifts

Giving closely held stock can be advantageous for many reasons. For example, it allows the giver to avoid long-term capital gains tax obligations on appreciation and lock in the current value for gift tax purposes. If those shares aren't transferred until the giver's death, the estate generally will include the stock's date-of-death value, including any appreciation.

Stock gifts can be particularly useful when given to family members in lower tax brackets than the giver. While the giver's tax basis in the gifted stock for income tax purposes will transfer to the recipients, they can sell the appreciated shares and pay no capital gains tax if they're eligible for the 0% long-term capital gains rate, or at least pay the tax at a lower rate than the giver if they qualify for the 15% rate and the giver would be subject to the 20% rate — and potentially avoid the 3.8% net investment income tax as well. Or the recipients might hold the shares and enjoy the future income.

However, if a taxpayer's estate likely won't exceed the available estate tax exemption even if it includes the appreciated stock, *bequeathing* the stock may save more tax overall for the family. The tax basis of bequeathed assets is generally stepped up at death to the date-of-death value. So the heirs' capital gains tax when they sell the stock may be significantly lower than if the stock had been gifted to them.

## Timely opportunity

Stock gifts may be appealing in today's volatile markets. Economic uncertainties could lower demand, increase costs, and alter capital structures and financing costs. For example, in recent years, some companies have taken on more debt at higher interest rates than in the past. To the extent that external factors decrease a business's expected cash flow or increase capital costs, its value will be lower.

At the same time, valuation discounts for lack of marketability and control in closely held businesses may have increased from previous years. The size of these discounts depends on the company's circumstances (including its financial performance). The upside to depressed stock prices is that business owners can transfer more shares to loved ones — and remove future appreciation from their estates — without eating into their exemptions as much as they would if the shares were worth more.

## Valuation matters

For gift tax purposes, stock gifts are valued on the transfer date. For estate tax purposes, stock bequests are valued on the date of death or the alternate valuation date, if elected, which is six months later. Determining the fair market value of a closely held company requires a formal business appraisal.

The IRS closely monitors intrafamily stock transfers — and undervaluation can lead to penalties, interest and additional taxes. The best way to withstand IRS scrutiny is to obtain an independent valuation by a credentialed expert. ■

# Fight fraud with whistleblower reporting mechanisms

Early fraud detection is essential to reducing financial and reputational damage. By far, the most effective detection method is whistleblower tips. They account for 43% of initial fraud detections according to a recent Association of Certified Fraud Examiners (ACFE) study. The ACFE encourages organizations to use formalized fraud reporting mechanisms to help facilitate tips and lower fraud risks.

## Additional findings

Over half (52%) of the tips reported in the ACFE's *Occupational Fraud 2024: A Report to the Nations* came from employees. Other notable tip sources include customers (21%) and vendors (11%). Roughly 15% came from anonymous sources. Additionally, the ACFE reports that organizations with formalized whistleblower channels generally detect fraud faster and lose less money. The median fraud duration and loss were 50% lower among organizations with hotlines than those without this anti-fraud control.

However, simply having a reporting system in place isn't enough. It must be reinforced by a culture that supports ethical behavior. The ACFE survey reveals that employees who receive fraud awareness training are twice as likely to report suspicious behavior than those who don't receive such training.

## 3 reporting mechanisms

It's also important for reporting systems to be well-designed, accessible, secure and cost-effective. Here's a breakdown of the three main types of reporting mechanisms:

**1. Telephone hotlines.** Once the gold standard, phone hotlines are now used by about 30% of organizations. While familiar, they can be expensive to manage, particularly if operated 24/7 or staffed by

third parties. This format might not guarantee complete anonymity, especially in smaller organizations.

**2. Email reporting.** While email reporting is inexpensive and easy to set up, employees may hesitate to submit concerns through a company-monitored system, fearing traceability or retaliation. This method also lacks real-time documentation and routing control, making it harder to manage workflow during a forensic accounting investigation.

**3. Online mechanisms.** Web-based platforms offer whistleblowers a more scalable, user-friendly and confidential way to submit reports. Many allow secure uploads, automated routing and built-in case tracking. Plus, workers can conveniently access these systems using personal mobile devices.

Online mechanisms were used by 40% of respondents to the 2024 study, surpassing telephone and email formats for the first time in the study's history. In 2020, these three reporting mechanisms were used essentially equally (about one-third of tips came from each).

## From insight to action

Empowering stakeholders with an accessible, trustworthy reporting mechanism is a strategic investment in risk management. A forensic accountant can provide more information about assessing fraud risks and designing an effective reporting mechanism based on an organization's size, structure and resources. ■

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# Oscher Consulting, PLLC

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