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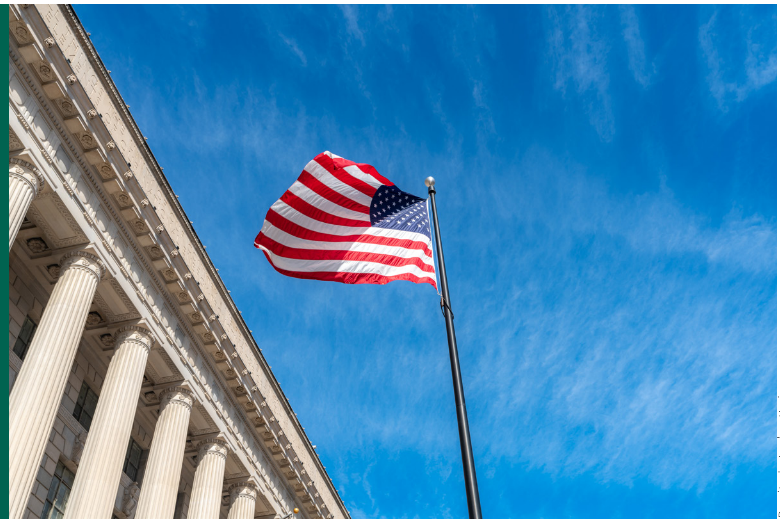

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## TAX COURT ALLOWS TAX-AFFECTING FOR THE DISCOUNTED CASH FLOW METHOD IN PIERCE V. COMMISSIONER

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*Pierce v. Commissioner* is the latest case to be decided that addresses the appropriateness of including income tax in the valuation of a privately held company organized as a pass-through entity. But the decision also addressed financial forecasts, company-specific risk, and excess working capital, among other elements of business valuation.

### Introduction

On April 7, 2025, the U.S. Tax Court (the "Tax Court") issued its opinion (the "memorandum") in *Pierce v. Commissioner*[1] on the valuation of common stock interests in a privately held business that was organized as a pass-through entity—specifically, a limited liability company taxed as an S corporation.

The Tax Court agreed with both experts' inclusion of projected income tax expenses at the entity level (otherwise referred to as tax-affecting) in forecasted net cash flow used for the discounted cash flow ("DCF") method of valuation.

Prior to this case, the Tax Court delivered mixed results on the use of tax-affecting, with some opinions in favor and others against the practice. The scorecard, along with certain language expressed in *Pierce*, suggests that the Tax Court is inclined to continue deciding each case on its own merits, rather than etch in stone a prescription for all cases.

### Pierce v. Commissioner

Pierce, the taxpayer petitioner, and his wife owned a business called Mothers Lounge, LLC ("Mothers Lounge") and, for estate planning purposes, made gifts of common stock shares in Mothers Lounge during 2014 to various trusts. During 2016, the Internal Revenue Service ("IRS") audited the Forms 709 for gift tax and challenged the valuations presented as being lower than its own estimate of fair market value, alleging a gift tax deficiency.

Upon receiving a notice of deficiency, Pierce and his wife hired a different independent valuation expert to estimate the fair market value of the common stock shares and issue a report, while the IRS hired its own independent expert. (Pierce's wife later settled separately.)

On brief, in a partial concession, the IRS took the position that the correct fair market value should be lower than what it originally estimated, and the IRS's expert applied tax-affecting in his DCF method of valuation.

The memorandum provides for entertaining reading—it dives into unseemly matters, such as cheap knock-off products made in China and then given away for the cost of shipping, poaching product ideas by trolling trade shows, an alleged extramarital affair by Pierce with an employee that affected operations and sales, and a probe by the Federal Bureau of Investigation ("FBI") of another employee's alleged blackmail of Pierce for $100,000. (The employee allegedly planted keyboard-stroke-tracking software on his boss's computer.) Before addressing specific elements of the company valuation toward its conclusion, the memorandum thoroughly traces the evolution of Mothers Lounge and cogently describes its business model with an impressive level of detail.

The following are the key elements of valuation analysis addressed and decided by the Tax Court as they applied to this specific case:[2]

- Tax-Affecting Forecasted Cash Flow – The Tax Court agreed with applying federal and state income tax expenses to forecasted cash flow for the DCF method to valuation (an income approach). Pierce's expert and the IRS's expert tax-affected forecasted cash flow in their DCF analysis, which was the only valuation method relied on by each expert. The Tax Court recognized that "where, as here, the data used to value an S corporation is largely based on the data from C corporations, proponents of tax affecting believe that the mismatch from pretax cash flow and after-tax discount rates must be adjusted through tax affecting to ascertain the fair market value of an S corporation."[3]

- Forecasted Revenue and Expenses – The Tax Court rejected the cash flow forecasts relied on by the IRS's expert, finding that his use of the original forecasts prepared by Pierce's expert for the gift tax filing lacked sufficient indication that he had reviewed, analyzed, and provided support for the use. The memorandum stated that the IRS's expert did not address adverse material events. The Tax Court accepted the projections used by Pierce's expert, which were *de novo* forecasts prepared independently by the expert rather than by company management.

- The Consideration of Post-Transaction Events Affecting Valuation – The Tax Court accepted the revised forecasts made in 2024 by Pierce's expert, despite his incorporating events that occurred after the valuation date, on the premise that the events were reasonably known or knowable as of the valuation date. Pierce's expert provided ample market research that satisfied the Tax Court.

- Company-Specific Risk Factor in Cost of Equity for Present Value Discounting – The memorandum stated that "we have previously accepted company-specific risk adjustments where a company had the possibility of an unsustainable business model."[4] The memorandum further stated that "a company-specific risk premium must not include factors already accounted for in determining the cost of equity," citing *Rakow v. Commissioner*, whose decision rejected the premium on the notion that such risks were "covered by the size risk premium including a smaller geographic area, lack of management depth, and less access to capital markets."[5] Pierce's expert added a 5 percent company-specific risk premium ("CSRP"), which the Tax Court rejected due to a lack of explanation as to how he arrived at that figure. The memorandum states that "we would also expect that Mr. Pickett would qualify each risk by the probability of the risk's occurring."[6]

- Excess Working Capital – The Tax Court accepted the estimate of excess working capital made by Pierce's expert, who analyzed historical working capital (defined as including cash and short-term debt) as a percentage of revenue. The memorandum pointedly mentioned that it accepted the analysis of Pierce's expert because of the metric he applied, whereas the IRS's expert analyzed historical working capital as a percentage of total assets.

A discussion and analysis of each major point of contention follows.

## Tax-Affecting Forecasted Cash Flow

Mothers Lounge, a limited liability company, elected to be taxed as an S corporation, otherwise known as a pass-through entity. The following are the key differences between a C corporation (as are most publicly traded companies in the U.S.) and a pass-through entity (as are typically privately held companies and partnerships in the U.S.):

- C corporations are subject to corporate income taxes at the entity level. Conversely, the shareholders of pass-through entities (such as Mothers Lounge) recognize on their personal income tax returns a pro rata share of the reported net taxable income of the S corporation.
- Dividends from C corporations are subject to dividend income tax rates at the shareholder level. Conversely, dividends (in an amount in excess of the income tax due on the S corporation's taxable income) received by shareholders of S corporations are not subject to income taxes.
- The undistributed income of an S corporation increases the tax basis of its equity securities. Conversely, the undistributed income of a C corporation does not change the tax basis of its equity securities.

The IRS generally has been reluctant to accept the notion of tax-affecting a pass-through entity's forecasted cash flow when applying the income approach to valuation—arguing for *zero* tax expense to be applied in such cases. The Tax Court has sometimes ruled in favor of tax-affecting, sometimes not. A recent example of ruling against tax-affecting would be *Estate of Michael Jackson v. Commissioner*, in which the Tax Court did not accept the argument that the most likely hypothetical buyer of the subject interest would be a C corporation.[7]

Interestingly, in *Pierce*, tax-affecting was not a bone of contention because both sides' experts applied the procedure. The Tax Court accepted the discrete tax rate selected by Pierce's expert, but there was not much difference between the two experts' selected tax rate. The memorandum, however, used language cautioning that the Tax Court was inclined to continue judging each case on its own facts and circumstances and that its decision in this matter was not intended to be binding precedent: "In limited circumstances, the Court may allow the earnings to be 'tax affected' by applying a hypothetical entity-level tax."[8] It cited *Estate of Cecil v. Commissioner*[9] and *Estate of Jones v. Commissioner*[10] (for which Willamette Management Associates served as the expert witness for the taxpayer), in which the Tax Court allowed tax-affecting.

In explaining its rationale for allowing tax-affecting in *Pierce*, the Tax Court included the following language: "Proponents of tax affecting argue that it is necessary to account for the fact that valuation data used in valuing an S corporation is based on data from C corporations, which pay an entity-level tax,"[11] citing *Dallas v. Commissioner.*[12] The Tax Court likely was referring to each expert's inclusion of an industry risk premium derived from observed market data of publicly traded C corporations when estimating the cost of equity, which is used for present value discounting of forecasted net cash flow. In estimating the cost of equity, each expert used what is called the build-up model, which adds an industry risk premium.

## THE IRS GENERALLY HAS BEEN RELUCTANT TO ACCEPT THE NOTION OF TAX-AFFECTING A PASS-THROUGH ENTITY'S FORECASTED CASH FLOW WHEN APPLYING THE INCOME APPROACH TO VALUATION.

One alternative may be to estimate the cost of equity using the modified capital asset pricing model, which includes a selected beta (multiplied by the equity risk premium) that is drawn from one's analysis of the betas of selected guideline publicly traded companies for comparison. These betas are on a levered basis—they factor in the capital structures of the companies—and are then unlevered and relevered by the valuation analyst according to the capital structure of the subject company. Not only do the betas of the publicly traded companies reflect their tax status as C corporations, but one particular method of unlevering and relevering the betas using the subject company's own capital structure—the Hamada formula—includes tax rates in its formula.[13]

Ibbotson Associates for decades until being owned by Kroll, LLC published equity risk premium data from publicly traded companies that were relied on by many practitioners of the independent valuation consulting industry. Ibbotson Associates' annual publication stated that "the equity cost of capital is equal to the expected rate of return for a firm's equity; this return includes all dividends plus any capital gains or losses."[14]

In explaining its reason for accepting tax-affecting in *Estate of Adams v. Commissioner*, the Tax Court cited Roger Ibbotson: "All of the risk premium statistics included in this publication are derived from market returns by an investor. The investor receives dividends and realizes price appreciation after the corporation has paid its taxes but before personal taxes. When performing a discounted cash flow analysis, both the discount rate and the cash flows should be on the same basis."[15]

There is empirical evidence that investors in fixed-income securities also consider income tax in their required rate of return (or discount rate). Investors will accept lower rates of return on double-tax-exempt municipal bonds compared to bonds whose interest income is taxed at the individual level. This supports the notion that investors evaluate investments based on net proceeds after taxes to the investor, regardless of whether the tax liabilities are incurred at the entity level or personal level.

## Forecasted Revenue and Expenses

The revenue, earnings, and net cash flow forecasts prepared by Pierce's expert were accepted by the Tax Court. The use of such forecasts—whether by the company, by the expert with involvement from the company, or by the expert independently—also has been heard before the Delaware Court of Chancery ("Chancery"). The following are some of the cases when Chancery accepted or rejected forecasts that were prepared by the management of the subject company or by its advisors:

- Rejection of Management-Prepared Projections in *In re Appraisal of PetSmart Inc.* – Vice Chancellor Slights of Chancery noted that projections in prior cases have been found to be unreliable when "the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, where the projections were created for the purpose of obtaining benefits outside the company's ordinary course business, where the projections were inconsistent with a corporation's recent performance, or where the company had a poor history of meetings its projections."[16] The Court also observed that management had no history of creating long-term projections beyond short-term earnings guidance.

- Acceptance of Management-Prepared Projections in *Cede & Co. v. Technicolor, Inc.* – Chancellor Chandler of Chancery accepted company projections and rejected the petitioner expert's alteration of those projections, writing that "When management projections are made in the ordinary course of business, they are generally deemed reliable."[17] The opinion also noted that management had a good track record of meeting earnings projections.

THERE IS EMPIRICAL EVIDENCE THAT INVESTORS IN FIXED-INCOME SECURITIES ALSO CONSIDER INCOME TAX IN THEIR REQUIRED RATE OF RETURN (OR DISCOUNT RATE).

- Rejection of Third Party-Prepared Projections in *In re Radiology Assocs., Inc.* – Chancery rejected the petitioners' valuation method because the inputs were too speculative, largely due to the fact that management neither created them nor gave any guidance to the third party that created them.[18]

- Acceptance of Second Set of Projections Based on Growth-Oriented Plans in *Delaware Open MRI Radiology v. Kessler* – Vice Chancellor Strine of Chancery opined the following about the fairness opinion's exclusion of projections that were based on the company's expansion plans: "In essence, when the court determines that the company's business plan as of the merger included specific expansion plans or changes in strategy, those are corporate opportunities that must be considered part of the firm's value"[19] as a going concern.

- Acceptance of Second Set of Projections Based on Growth-Oriented Plans in *In Re United States Cellular Operating Company* – Vice Chancellor Parsons of Chancery ruled that projections should have included reasonably anticipated capital expenditures, stating, “This is not a situation where projecting capital expenditures to account for conversion to 2.5G and 3G is speculative. Industry reports included such expenditures and the Companies themselves ‘anticipated’ it. Therefore, Harris should have incorporated the effects of this expected capital improvement in his projections.”[20] It was also noted that, under other circumstances, the court “should avoid, however, speculative costs that are not part of the company’s operative reality.”[21]


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This case was particularly interesting because company management had no prior experience with making long-term projections. The fairness opinion was rendered by a firm that worked alongside management developing a reasonable set of projections. The projections were based on such factors as anticipated subscriber growth driven by population growth, market penetration, and customer churn. Consequently, the two experts for this case had no projections prepared solely by company management. Instead, the experts had projections that were created by an investment bank with the assistance of company management. Both experts used these projections as a starting point and made adjustments.

- Rejection of Second Set of Projections Based on Growth-Oriented Plans in *In re PLX Technology Inc. Shareholders Litigation* – Vice Chancellor Laster of Chancery rejected the use of a second set of projections that were based on growth initiatives, despite the projections having been prepared in the ordinary course of business. In reaching its decision, the court reasoned that “to achieve even higher growth rates, particularly in 2017 and 2018, the December 2013 Projections contemplated a third layer of future revenue. It depended on PLX introducing a new line of ‘outside the box’ products that would use the ExpressFabric technology to connect components located in different computers, such as the multiple servers in a server rack. To succeed with this line of business, PLX would have to enter the hardware market and compete with incumbent players like Cisco.”[22]

- Rejection of Second Set of Projections Based on Growth-Oriented Plans in *In re Micromet, Inc. S’holders Litig.* – Chancery addressed the plaintiff’s claim that the board had breached its fiduciary duty of disclosure by failing to disclose certain financial projections that were ultimately not relied on for the fairness opinion. The court stated, “Micromet was not required to disclose the ‘Upside Case’ projections that Micromet’s management provided to Goldman. Again, these projections were not relied upon by Goldman in its fairness opinion and at least some of the directors found the projections to be unreliable and overly optimistic.”[23]

In the case of mergers and acquisitions, the investment bank serving as financial advisor to a target company’s board of directors may assist in making or revising financial projections. This is particularly true if the company is not well-versed in making long-term projections. It is not uncommon for the target company to provide financial projections based on generally accepted accounting principles (“GAAP”). The banker will convert the GAAP-based projected net income to cash flow for the sake of valuing the company using the DCF method.

When provided with multiple sets of financial projections, the advisor rendering a fairness opinion about a merger or acquisition uses a fair degree of judgment in assessing the reliability of each set of projections. If growth-oriented financial projections are based on proven science or manufacturing processes, the financial advisor may view the projections as reliable. However, if the growth scenario involves speculative projects, such as introducing a new product or service, the projections may be untenable and unreliable for purposes of a fairness opinion analysis. These considerations—whether to rely on multiple sets of financial projections—also apply to independent valuation analysts who prepare analyses for post-transaction shareholder litigation.

## Pierce's Projections

In *Pierce*, the Tax Court accepted the projections used by Pierce's expert, which were *de novo* forecasts made by the expert independently rather than being prepared by company management. The alternative would have been to accept the original forecasts relied on by the IRS's expert.

However, the Tax Court was unimpressed by the scant analysis by the IRS's expert of the underlying data and assumptions of the old set of forecasts, adding that "Mr. Mitchell testified generally that he reviewed and agreed with the conclusions in the 2017 Lone Peak report. However, when pressed on the issue he stated that he did not independently verify any of the data in the report nor did he conduct any tests to determine the reliability of the 2017 Lone Peak report."[24]

The Tax Court opined that the original set of forecasts relied on by the IRS's expert did not incorporate various challenges faced by Mothers Lounge around the valuation date, such as (1) the impact of Pierce allegedly engaging in an extramarital affair that made the gossip circles in the industry and was discussed on social media sites, (2) the FBI's investigation into the alleged blackmail of Mr. Pierce by an employee, and (3) Mr. Pierce's wife's banning her husband from attending trade shows over the alleged affair—trade shows were a major source of new product ideas—among other strife-inducing changes to their working relationship.

Apparently, the Tax Court believed that the negative effect on future sales stemming from these challenges was not reflected entirely by the original forecasts, so the Tax Court accepted the *de novo* forecasts prepared by Pierce's expert.

The IRS's expert rebutted many assumptions made by Pierce's expert—unconvincingly—as the Tax Court observed, "Respondent does not offer an alternative industry for forecasting purposes."[25]

The following were some of the assumptions made by Pierce's expert, based on his independent market research, that sufficiently impressed the Tax Court to accept his *de novo* forecasts:[26]

- Pierce's expert forecasted that after 2014, sales would decline to the growth rate of the online baby products industry through 2017, before declining to a long-term growth rate of 3 percent.

THE TAX COURT WAS UNIMPRESSED BY THE SCANT ANALYSIS BY THE IRS'S EXPERT OF THE UNDERLYING DATA AND ASSUMPTIONS OF THE OLD SET OF FORECASTS.

- Pierce's expert forecasted that operating margin would decline precipitously to 7.4 percent by 2017 from 28.9 percent in 2013. This was premised on the unsustainability of the business model, which relied on (1) poaching product ideas from trade shows to create cheap knock-offs produced in China; (2) giving the products away for free through coupons placed in shopping bags at one retailer, through a partnership; (3) deriving revenue solely from shipping costs well above the manufacturing and logistics costs per unit, resulting in robust margins despite giving the products away for free; (4) creating a subsidiary for each product so customers could not bundle requested merchandise in one package with a single, lower shipping cost.

- Pierce's expert used market research, such as from IBISWorld, and narrowed his comparisons to the online baby product industry rather than including retail stores.

- Pierce's expert's forecasts assumed that the high profit margins of Mothers Lounge coupled with low barriers to entry would cause its profit margins to decline to the industry average as new companies entered the market.
- Pierce's expert noted that, as of the valuation date, big retailers such as Target and Walmart were more aggressively entering the online baby products market and offered free shipping, customer support, and a no-hassle return policy (unlike Mothers Lounge). They had already demonstrated increasing market penetration in the year before the valuation date, with no signs of that abating.
- Pierce's expert noted that Mothers Lounge eschewed social media marketing channels because it feared unhappy customers would spread the word.
- Pierce's expert noted that Mothers Lounge would have had difficulty reducing its prices as competition arose and could not list products on websites such as Amazon because it would undermine sales from the websites of its own subsidiaries, whose prices were higher than they would have been selling through Amazon.
- Pierce's expert noted that Google had changed its algorithms near the valuation date to flag and filter promotional emails containing the word "free."

When the IRS's expert argued that Mothers Lounge could have changed its business model to a more traditional one, the memorandum observed that the company had already attempted that in 2011 and failed and that "Mothers Lounge was effectively locked into a free, just pay shipping model."[27]

## Post-Transaction Events

In this particular case, the Tax Court accepted the revised forecasts made in 2024 by Pierce's expert despite his incorporating events that occurred after the valuation date. This is because these events had their genesis before the valuation date, such as pressure on sales and profits and increased competition, which showed no signs of ameliorating. Pierce's expert was thorough in his market research and explanations of the selected inputs in his forecasts. This is akin to reasonably expecting a train to arrive at a station after the valuation date as long as it left the prior station before the valuation date.

## CSRP Included in the Discount Rate

The Tax Court rejected the inclusion of an extra 5 percent to the cost of equity for risks above and beyond comparisons to the betas of guideline publicly traded companies. This is known as the CSRP.

Although it recognized that the CSRP has been accepted in courts before, the Tax Court took issue with the simplistic selection of this discrete 5 percent rate without quantification of how it was derived. In acknowledging its existence conceptually, the memorandum cited *Estate of Adams* when it was accepted because there was a strong likelihood that the company's business model was unsustainable.[28] The Tax Court noted that when this risk is incorporated in a discount rate, it must be separate from other risks already incorporated into either forecasts or other inputs such as the beta and size risk premium.

A selected CSRP, in general, may include an analysis of the following, as opined by valuation practitioner Gary Trugman in *Understanding Business Valuation*:

- Economy risk and conditions
- Operating risk
- Asset risk
- Market risk
- Regulatory risk
- Business risk
- Financial risk
- Product risk
- Technological risk
- Legal risk
- Location of business
- Depth of management
- Barriers to entry[29]

In addition to those cited by Trugman, risks stemming from a lack of management depth may include consideration of whether the company holds life insurance policies on the lives of management and whether certain officers hold key customer relationships that would impact sales if they were no longer employed by that company.

Pierce's expert cited the following company-specific risk factors:

- The terminable nature of the Destination Maternity contract, which represented 20 percent of revenue
- A possible loss of the Bebe Au Lait lawsuit that would render the business plan useless
- Limited success of the free, just-pay-shipping model
- The impact of marital strife on company operations
- The avoidance of using social media[30]

## SOME VALUATION ANALYSTS HAVE ATTEMPTED TO USE WHAT IS CALLED A "NUMERIC PROCEDURE," WHEREBY THE VALUATION ANALYST ASSIGNS A SPECIFIC PERCENTAGE NUMBER TO EACH INDICATED CSRP FACTOR.

Pierce's expert testified at trial that, in his estimation, the addition of a CSRP of 5 percent would decrease the company value by 19 percent versus not including this risk factor. The memorandum, in addition to being dissatisfied with the lack of a methodology to arrive at the 5 percent CSRP, also wondered why Pierce's expert did not "qualify each risk by the probability of the risk's occurring."[31]

The inclusion of a CSRP, when appropriate and supported, as long as it does not double up on the same risk factors already impounded in other metrics, is not unusual among valuation professionals. In *Business Valuation and Taxes*, former Tax Court judge David Laro and valuation practitioner Shannon Pratt observed that:

> The company-specific adjustment is usually in the range of negative 2 percent to positive 5 percent, but sometimes falls outside that range, and is occasionally as high as positive 10 percent. A 10 percent adjustment could be warranted in extreme circumstances such as a startup company or a financially distressed company.[32]

In addition to incorporating risks specific to the company in excess of empirical market data from publicly traded guideline companies, the CSRP is sometimes used when projections are deemed too optimistic. This was addressed in a Harvard Business School working paper published in 2010:

> Including a company specific risk premium to account for differences between the forecasted and expected cash flows is generally accepted by valuation professionals. The publications of the American Society of Appraisers and the American Institute of Certified Public Accountants suggest in their guides to valuation that company specific risk premium should be included in the discount rate as an adjustment for the riskiness of the forecast. These adjustments are qualitative, at best. The ASA manual explains that "there are few objective data and no quantitative means of establishing the company-specific risk premium. It is largely a matter of judgment and experience."[33]

### Attempts at a Solution

The quandary presented by the Tax Court's desire of a quantitative methodology supporting the discrete selection of a CSRP is, of course, what would satisfy the court?

In this spirit, some valuation analysts have attempted to use what is called a "numeric procedure," whereby the valuation analyst assigns a specific percentage number to each indicated CSRP factor. If the analyst assigns "2.0" to a particular factor, that indicates that the analyst will add two percentage points to the ultimate selection of the CSRP factor. If the analyst assigned "(1.0)" to a particular factor, that means that the analyst will subtract one percentage point from the ultimate selection of the CSRP. And if the analyst assigns "0" to a particular factor, that factor has no impact on the final CSRP. The selected CSRP is the sum of all of the individually assigned numeric values for each selected factor.

Although this method shows some calculus for the discrete CSRP, professional judgment still is involved with assigning numbers to each risk factor. So, what is the answer?

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To muse over a potential solution to this impasse, let us revisit the testimony of Pierce's expert, when he estimated that his selected CSRP reduced the company value by 19 percent. The implied CSRP may be "teased out" through backsolving by comparing two sets of forecasts: (1) a baseline set of forecasts and (2) a second set of forecasts using the baseline as a starting point. Then, the probability-weighted economic impact could be estimated if the identified risk factors came to bear. It would behoove one to be thoughtful in assigning the probabilities, with consideration given to whether some are mutually exclusive between each other. If there is a high probability of an adverse event, perhaps that risk factor should have been included in the baseline financial forecasts.

Then, the analyst would backsolve the implied CSRP, which would make the indicated enterprise value ("EV") using the baseline forecasts (which exclude a CSRP) equal to the indicated EV using the probability-weighed riskier forecasts. However, would clients of independent valuation firms be willing to pay for this extra layer of work for gift tax purposes? Would clients spurn firms that use this methodology at a higher cost, preferring lower-fee firms that would not perform this additional procedure? Would clients even know and appreciate that the valuation analyst's higher fees were because they performed an additional layer of analysis to support their opinion of value?

## Excess Working Capital

The memorandum addressed the topic of excess working capital using the definition of working capital as total current assets less total current liabilities.

The alternative would have been to use the metric net operating working capital, which excludes cash and short-term debt. The adjustment for cash, in and of itself, to arrive at an indicated value of total equity is affected by whether cash had been subtracted from debt by the valuation analyst for analysis of market data and metrics from publicly traded guideline companies, such as in valuation multiples to earnings and beta calculations.

The memorandum referred to the adjustment to value by Pierce's expert based on his working capital analysis as being "excess cash"[34] and mentioned that Mothers Lounge "maintained few assets other than inventory"[35] (presumably, in addition to cash on hand).

The memorandum did not delve into some other details, such as whether each expert first arrived at EV or market value of invested capital ("MVIC"). EV is defined as market capitalization plus debt minus total recorded cash, whereas MVIC is defined as market capitalization plus debt. When a valuation analyst wishes to arrive at MVIC, the valuation analyst does not deduct cash from market capitalizations of guideline publicly traded companies to derive market-based multiples to financial results (when applying the market approach to valuation) or to compare capital structures for unlevering and relevering observed betas and for weighting the cost of equity and cost of debt to arrive at a weighted average cost of capital (when applying the income approach to valuation). Instead, some level of cash may be added to the value of equity if it was concluded that it was in excess of what was necessary for operations.

To calculate the indicated value of total equity when first arriving at a subject company's estimated MVIC, the valuation analyst would subtract all interest-bearing debt and either not add any cash—if all cash was concluded to be necessary for working capital needs—or add an amount that represents the analyst's estimate of the excess working capital.

Alternatively, to calculate the indicated value of total equity when first arriving at a subject company's estimated EV, the valuation analyst would subtract all interest-bearing debt but then add *all* recorded cash to arrive at the indicated value of total equity. If EV were the starting point of the analysis before making adjustments to arrive at the value of total equity, after adding all cash and subtracting all debt, the valuation analyst may conclude that there is some level of excess *net* operating working capital beyond whatever level of cash exists.

## SOME LEVEL OF JUDGMENT IS INVOLVED IN ESTIMATING EXCESS LEVELS OF WORKING CAPITAL (OR NET OPERATING WORKING CAPITAL).

Without the benefit of seeing the expert reports in Pierce, we do not know the level of detail in the experts' analysis of working capital sources and uses, such as whether Mothers Lounge had an available line of credit or, if there was no line of credit available, whether there were certain years in the company's history when a setback required the company to use more cash for operations than usual.

The Tax Court rejected the working capital analysis by the IRS's expert, who compared working capital to total assets in estimating the level of any excess that should be added to the value of equity. Comparing net current assets to total assets was not only rejected by the Tax Court in this case, but it also was written by Laro and Pratt that "the most common category of controversy regarding excess or deficient assets involves working capital. The most common measurement of the adequacy of working capital is the amount of working capital as a percentage of the company's sales."[36] One flaw, among others, in comparing short-term assets to total assets is that in some industries, certain companies may hold long-term assets consisting of nonoperating partnership holdings or goodwill from acquisitions, which renders dubious simple comparisons of assets to assets.

If market comparisons are made in working capital analysis to decide whether there is any excess, regardless of whether by comparison to publicly traded companies or the use of industry surveys by the Risk Management Association, a valuation analyst's ham-handed selection of the median of the publicly traded companies' working capital to revenue just because it appears to be an incontrovertible middle ground is untenable without supporting analysis. In areas involving an analyst's judgment, more supporting analysis is better than less.

Laro and Pratt state that "if working capital is within a reasonable range relative to the benchmarks, no adjustment is ordinarily required."[37] In a narrative report, it behooves the analyst to present sufficient supporting analysis in exhibits and written language—beyond simply calculating a low and high end and estimating either some or no excess level based on where it falls within that range.

Sufficient support for one's findings seems to be much appreciated by the Tax Court because some level of judgment is involved in estimating excess levels of working capital (or net operating working capital). There are limits to any attempts to automate this process as a black box. Some examples of these limitations to taking any shortcuts in one's analysis are:

- Some companies may, in their Forms 10Q and 10K, lack headers distinguishing between short-term and long-term assets. They may simply list all assets in descending order of liquidity.
- Subscription databases may create a generalized category for an asset when it may behoove the analyst to scrutinize this line item and read the notes to the filing.
- A guideline publicly traded company used among others to compare levels of working capital may have recorded a significant current liability for income taxes payable on its balance sheet, even exceeding total current assets, leading to negative working capital, which arose from the terms of an acquisition. After closing, the terms of the transaction may beget certain contingent assets or liabilities, whereby the

acquirer and target split the benefits or liabilities of certain tax items, such as a net operating loss carryforward. For the purposes of drawing ratios from publicly traded companies to compare to a subject company, it may be debatable whether a short-term liability such as this should be included in working capital. This liability may be contingent on unforeseen events that may prove an estimate of this liability incorrect, related to estimates of tax basis increases or tax receivable agreements.

- In Forms 10-Q and 10-K, only the written "notes" to financial statements may explain a company's policy on maintaining certain levels of working capital and whether the level as of the date of the filing was adequate or excessive.

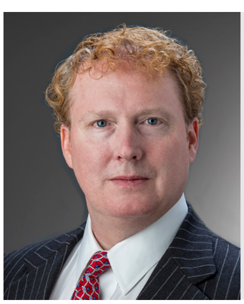
## Conclusion

The Tax Court in *Pierce* accepted the incorporation of tax-affecting when valuing a privately held limited liability company but demurred to take a stance that its ruling was a one-size-fits-all suit to be worn for all events. Concrete empirical evidence may be unearthed from a yet-to-be conducted professional survey of a decent sample size of investment bankers, with a few simple yes or no questions: Do you incorporate income taxes when you value the total equity of a client that is the target of an acquisition overture? Do the investment bankers representing the acquirer do the same? Is this often an impasse?

The Tax Court also weighed in on a few other elements of both experts' valuation analysis:

- The Tax Court accepted the *de novo* forecasts prepared independently by Pierce's expert, including an explanation as to why certain events occurring after the valuation date were known and knowable and, therefore, may be included. The memorandum indicated satisfaction with the level of research and analysis by Pierce's expert and dissatisfaction with such by the IRS's expert.
- The Tax Court rejected the inclusion of a 5 percent CSRP in the cost of equity for present value discounting. While acknowledging its applicability in some cases, the Tax Court was dissatisfied with the lack of support for how Pierce's expert arrived at this figure and why the expert did not factor in probabilities of outcomes for the various risk factors.
- The Tax Court accepted the estimate of the level of excess working capital made by Pierce's expert, on the premise that he correctly compared working capital to revenue, whereas the IRS's expert compared working capital to total assets.

## About the Author



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## References:

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2 The memorandum made it clear that the Tax Court was not advocating the application of tax-affecting in all cases and that its opinions related to the facts and circumstances of this particular case.

3 Pierce, T.C. Memo 2025-29 at 18.

4 Ibid., at 19.

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7 Estate of Michael Jackson v. Commissioner, T.C. Memo 2021-48 (May 3, 2021).

8 Pierce, T.C. Memo 2025-29 at 14.

9 Cecil v. Commissioner, T.C. Memo 2023-24 (Feb. 28, 2023).

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30 Pierce, T.C. Memo 2025-29 at 20.

31 Ibid.

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33 Richard S. Ruback, “Valuation when Cash Flow Forecasts are Biased,” (Harvard Business School working paper 11-036; 2010), 4.

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