

Court Case Update: Important Rulings for Closely Held Business & Private Client Advisors



Business Valuation
& Advisory

Today's Agenda

Four Important Cases Impacting Clients

Estate of Galli (2025) - Intrafamily loans and Section 7872 safe harbor

Pierce v. Commissioner (2025) - S Corporation tax affecting methodology

Connelly v. United States (2024) - Corporate-owned life insurance treatment

Huffman v. Commissioner (2024) - Section 2703 buy-sell agreement compliance

*Each case provides critical guidance for valuation disputes and
succession planning in closely held businesses*



Estate of Galli v. Commissioner (2025)

Transaction Details

- Barbara Galli (age 79) lent son Stephen \$2.3 million in February 2013
- Simple, unsecured promissory note dated February 25, 2013
- Interest rate: 1.01% - precisely the mid-term AFR for February 2013
- Terms: 9-year term, annual interest-only payments, balloon principal at maturity
- Performance: Stephen made all required payments (2014, 2015, 2016)
- Barbara reported interest income on tax returns
- Barbara died March 7, 2016; estate valued note at \$1,624,000 (discounted \$676,000)

Critical Omission

Barbara never filed Form 709 for 2013, leaving the transaction open to IRS examination beyond the normal statute of limitations. While the Estate won, it faced the uncertainty and costs of litigation.

Galli: IRS Position & Arguments

Notice of Deficiency Language

"The note lacked provisions necessary to create a legally enforceable right to repayment reasonably comparable to the loans made between unrelated persons in the commercial marketplace. It has not been shown that the borrower had the ability or intent to repay the loan."

IRS Theory

- Claimed partial gift of \$869,000 (alternative: \$544,000)
- Argued: "The amount by which the value of money lent in 2013 exceeds the fair market value of the right to repayment"
- Sought to apply Section 2512 fair market value principles
- Asserted "duty of consistency" for estate tax valuation

Evidence Submitted

IRS provided only "a declaration in support of the uncontested fact that Barbara Galli did not file a gift-tax return"

Galli: Court's Analysis & Ruling

Judge Holmes' Decision (March 5, 2025)

"We determine that the Commissioner is not asserting that the transaction was entirely a gift and would lose on the proof if he were. That leaves us to apply section 7872, and under that section, this transaction was not a gift at all."

Legal Foundation - Frazee v. Commissioner

"Congress indicated that virtually all gift transactions involving the transfer of money or property would be valued using the current applicable Federal rate... Congress displaced the traditional fair market methodology of valuation of below-market loans by substituting a discounting methodology."

Estate Tax Valuation

"If the note is valued on the estate-tax return at less than face value, that is simply a reflection of different rules on characterizing transfers as gifts and loan valuation for the estate tax—not any violation of any duty of consistency."

Galli: Why the Taxpayer Won

Evidence Stephen Submitted

- Copy of mom's bank record showing \$2.3 million transfer
- The executed promissory note signed by both parties
- His own bank records showing annual interest payments
- Barbara's income tax returns reporting interest income

Success Factor	Galli Implementation	Court's View
Documentation	Written, signed note	Essential for bona fide debt
Interest Rate	Exactly 1.01% AFR	Engaged §7872 safe harbor
Performance	All payments made timely	Strongest evidence of loan
Tax Reporting	Interest reported as income	Reinforced characterization

Contrast with Estate of Bolles:

"Purported loans were reclassified as gifts due to no payments and no ability to repay"

Pierce v. Commissioner (2025)

Business & Transaction Details

- Mothers Lounge, LLC - e-commerce nursing apparel via Amazon
- Minimal assets: small warehouse, primarily inventory
- June 2014 transactions:
 - Gift: 29.4% interest to Kaleb Jeremiah Pierce Irrevocable Trust
 - Sale: 20.6% interest to Giving Stream, LLC for \$3,419,600 note
- Pierce reported gift value at \$4,880,400 on Form 709
- IRS deficiency: \$4,824,160 plus penalties

The Core Valuation Dispute

Will the business maintain its 28.94% profit margins or decline to industry average of 7.4%?

Notable Agreement Between Experts

Both experts agreed to apply tax affecting using Delaware Chancery method - a significant development given historical controversy over S corp tax affecting

Pierce: The Battle of Pickett's Two Reports

Taxpayer Expert: Jeffrey Pickett's 2024 Litigation Report

- Business value: \$18,678,000 before discounts
- Pessimistic projections:
 - Profit margins compress from 28.94% to 7.4% industry average
 - Reasoning: Competition increasing, business model unsustainable
 - Considered 2014 known issues: FBI investigation, marital discord
- Applied 5% company-specific risk premium
- Tax affecting: 26.2% using Delaware Chancery method

IRS Expert: Mitchell Using Pickett's 2017 Appeals Report

- Business value: \$28,107,338 before discounts
- Optimistic projections (from 2017 Pickett report):
 - Assumed margins would remain high
 - Did not account for 2014 business problems
- Mitchell's critical error: Failed to independently verify the 2017 projections
- Tax affecting: 25.8% using Delaware Chancery method

"Mr. Mitchell testified that he reviewed and relied on, without independent verification of, the projections in the 2017 Lone Peak report"

Pierce: Why the Court Rejected Mitchell's Valuation

The Problem with Using Stale Projections

"Functionally, we are comparing two reports from Mr. Pickett: one from 2017 and another from 2024... We easily reject Mr. Mitchell's projections as knockoffs of the 2017 Lone Peak report."

Court's Key Finding

- Mitchell failed to independently verify Pickett's 2017 projections. The 2017 report was prepared for IRS appeals using post-valuation data and didn't consider known 2014 business challenges.
- This was a great example of the outcome being driven in large part by the credibility and diligence of the expert witness; the court meticulously scrutinized the experts' work and processes.

Connelly v. United States (2024)

The Life Insurance Valuation Challenge

- Crown C Supply Co. - building materials company
- Buy-sell agreement: corporation must redeem shares at death
- Corporation purchased \$3.5 million life insurance policies on each brother
- Michael died in 2013; corporation received \$3 million proceeds
- Estate reported Michael's 77.18% interest value: \$3,860,000
- IRS audit: Increased valuation to \$5,300,000

Core Dispute

Should life insurance proceeds used for share redemption be included in corporate value?

Connelly: Expert Opinions

Estate's Counsel:

"Crown's contractual obligation to redeem Michael's shares was a liability that offset the value of the life-insurance proceeds. Just as a corporation's obligation to pay for any other asset is a liability that reduces its value, so too is its obligation to pay for a decedent's stock."

>>>Relied on Estate of **Blount** (11th Circuit): proceeds "offset dollar-for-dollar"

IRS Expert: Evan Cohen (CFA)

"Allowing the redemption obligation to offset the insurance proceeds undervalues Crown C Supply's equity... and violates well-established equity valuation principles because the resultant share price creates a windfall for a potential buyer that a willing seller would not accept."

Connelly: Supreme Court's Unanimous Decision

The Holding

"An obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest."

The Court's Mathematical Example

"Consider a corporation with one asset—\$10 million in cash—and two shareholders, A and B, who own 80 and 20 shares respectively... To redeem B's shares at fair market value, the corporation would pay B \$2 million. After the redemption, A would be the sole shareholder in a corporation worth \$8 million with 80 outstanding shares. A's shares would still be worth \$100,000 each. Economically, the redemption would have no impact on either shareholder."

Action Item:

>>>Buy-Sell Agreements Funded with Corporate-Owned Life Insurance Should be Reviewed Immediately

Footnote: "We (the Court) do not hold that a redemption obligation can never decrease a corporation's value."

Huffman v. Commissioner (2024)

Family Business Structure

- Dukes, Inc. (later Infinity Aerospace) - aerospace manufacturing
- 1993: Parents Lloyd & Patricia grant son Chet right-to-purchase (RTP)
- Fixed price: **\$5 million** (no adjustment mechanism)
- Addendum: Chet could exercise "at any time of his choosing"
- Idea/Claim was that Chet accepted below-market compensation for years ("sweat equity")

The Transaction

- October 2007: Chet exercises rights, pays \$11.83/share
- IRS audit determination: FMV was \$74/share
- Total fair market value: **\$31.3 million**
- Alleged gift: **\$26.3 million**

Expert Valuations

- Taxpayer (Duff & Phelps): \$38.20/share with 16.7% key person discount
- IRS (Mr. Ruble): \$74/share (supported by Hanwha unsolicited, non-binding letter of intent indicating a valuation range of \$85-105M)

Huffman: The Lloyd-Barneson “Comparable”

Background on the Lloyd-Barneson Agreement

- 1990: Lloyd Huffman and unrelated shareholder Robert Barneson enter agreement
- Lloyd gets right to buy Barneson's 43% stake for max \$2/share
- Terms: Death trigger, right of first refusal, no termination date
- 1993: Lloyd assigns rights to son Chet, who buys shares for \$150,000

Why Taxpayers Used It as Evidence

- Huffmans argued Lloyd-Barneson proved unrelated parties accepted similar terms: (1) purchase rights on death, (2) maximum price cap, (3) no specific termination date

Court's Problems with This Evidence

- *"We do not have the Lloyd-Barneson agreement in evidence. We have only vague and incomplete references to it and testimony based on those references."*
- **No actual document:** Only one-paragraph references in other agreements
- **Critical differences identified:**
 - Lloyd could freely transfer his rights; Chet needed consent
 - Chet had "any-time" purchase right Lloyd never had
 - RTP agreements exempted Chet's brothers from right of first refusal

Huffman: Section 2703 Safe Harbor Tests

Test One: Bona Fide Business Arrangement - ✓ PASSED

- Court found legitimate business purposes: maintaining family control, rewarding key employee

Test Two: Not a Device to Transfer Wealth - ✓ PASSED

- Chet provided decades of below-market compensation
- Long-term acceptance of below-market compensation = "sweat equity"
- Economic substance beyond mere wealth transfer

Test Three: Comparable to Arm's-Length - ✗ FAILED

- "Any-time" exercise provision commercially unreasonable
 - "Chet had the unfettered right to purchase the Dukes shares at any time and at his sole discretion; Lloyd did not have this same right."
- Fixed price for 14 years with no adjustment mechanism
- Family-only carve-outs: Brothers exempted from right of first refusal
- Non-transferable rights: Chet couldn't transfer without consent
- Stated purpose: "To retain ownership within the Huffman family"

*****Result: Agreement disregarded, \$26.3M gift tax liability*****

Key Takeaways

Intrafamily Loans (Galli)

- Use AFR to engage Section 7872 safe harbor
- Document everything: note, payments, tax reporting
- File protective Form 709 to start statute of limitations

Business Valuations (Pierce)

- Expert credibility is key; experts must conduct their own analyses
- Tax affecting utilized by both experts; Tax Court accepts but falls short of establishing a new broad rule
- Delaware Chancery method continues to see acceptance on pass-through entity valuation

Life Insurance Planning (Connelly)

- Corporate-owned policies increase estate value
- Consider cross-purchase agreements or insurance LLCs instead
- Redemption obligations don't offset COLI proceeds

Buy-Sell Agreements (Huffman)

- Must be comparable to commercial transactions
- Avoid family-only provisions and "any-time" triggers
- Include pricing adjustment mechanisms, ideally based on fair market value and contemporaneous appraisal requirements