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A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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Facing the IRS:
Some Quick Tips to Make the Experience Less Painful

There comes a time in the careers of most valuation analysts when they end up having a valuation report reviewed by the Internal Revenue Service (IRS). This is understandably a stressful encounter, but knowing how to approach the IRS and what to expect from an audit can make a big difference in successfully resolving any issues.

Frequently the key to a good and fair review of a valuation report is getting in front of the right IRS person. Mike Gregory, who recently retired from the IRS and who served them for 28 years as an engineer and valuer, recently spoke to the Financial Consulting Group (FCG – www.fcgnetwork.org) in Atlanta about working with the IRS. FCG is the largest group of fraud and business valuation services firms in North America.

Mike pointed out that talking to the right person at the IRS is critical. Before you can find the right person, however, it helps to have an understanding of the basic structure of the IRS. There are four primary IRS compliance divisions: Wage and Investment; Large Business and International, Small Business/Self-Employed; and Tax-Exempt and Government Entities.

The Large Business and International Division is responsible for corporations, subchapter S corporations, and partnerships with assets greater than $10 million. It is organized into units that focus on six different industries:

- Communications, Technology and Media
- Financial Services
- Heavy Manufacturing and Transportation
- Natural Resources and Construction
- Retailers, Food, Pharmaceuticals and Healthcare
- Global High Wealth

In addition to these six areas, there is a support function in this division referred to as field specialists as well as "counsel," the IRS attorneys. Most notably, field specialists include IRS valuation engineers. Field specialists also include computer audit specialists, employment tax specialists, and financial products specialists and others. These field specialists can join an audit team for the Large Business and International Division on a referral basis when their expertise is deemed necessary for a particular audit. The economists, who formerly were in field specialists, are now in the International area of LB&I, but still work closely with field specialists.

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The Small Business and Self-Employed Division of the IRS is the largest division and has the most employees. While the Large Business and International Division deals with approximately 210,000 taxpayers, the Small Business Division handles over 55 million.

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In the Large Business and International Division, case managers routinely work with field specialists. The group managers in the Small Business and Self-Employed Division are far less likely to work with field specialists.

While the Large Business and International Division makes significant use of valuation engineers, they act as internal consultants to all divisions. There are four territory managers and 32 managers in the engineering program who oversee 300 technical employees. These include local valuations in the areas of both real property and business valuation.

Once a taxpayer's advocate is working with a case manager in the Large Business and International Division (whose team includes counsel and valuation engineers), the informal process of resolution begins. Mike Gregory outlines the process.

- What are the facts?
- What are the issues?
- How do you feel about these issues?
- What are your interests?

Once these questions are addressed, the process can move forward as over 400 IRS employees are trained in the process of mediation. Regarding valuation issues, Mike encourages those before the IRS to work with the case managers and request valuators be assigned to help address the issues. The case manager owns the case, but the valuators offer an opportunity to work with someone that understands valuation issues and terminology. With the assistance of a valuator, the case manager is the ultimate decision manager on the case. If needed, the valuator's engineering manager may also be called in. Nearly all cases can be resolved under examination.

If a case cannot be resolved at the audit level, it can move on to the appeals level. At appeals, the IRS typically only has "one bite at the apple," but the taxpayer can continue to petition for appeals until the issues are resolved. Counsel is involved in the Large Business and International Division and Appeals cases, but Mike cautioned those before the IRS to remember that the IRS considers valuation to be a matter of facts, not legal issues. As such, the facts govern the decision making on the case.

Perhaps the biggest issue that can arise for the valuation analyst before the IRS is the issue of appraiser penalties. Valuation penalties are the lesser of (1) the greater of 10% of the underpayment of tax attributable to the misstatement or $1,000 or (2) 125 percent of the gross income received by the person from the preparation of the appraisal.

Mike reassures those concerned about penalties to focus on meeting the valuation standards. Valuation analysts who meet their standards and who provide complete and thorough workpapers and engagement letters to the IRS should not have to fear the penalty statutes.

According to Mike, the majority of IRS valuation engineers have been through the NACVA training and, as such, will be most familiar with that organization's methods. He mentioned the key review areas in an estate and gift tax matter were:

- Discounts
  - DLOM (Discount for Lack of Marketability Job Aid for IRS Professionals, September 25, 2009)
  - Minority Interest Discount
- Discount Rates (Build-Up Method and CAPM)
- Cash Flow Adjustments
- Guideline Companies
  - Misuse of Transactional Database Data
  - Manipulation of the Data
- Standards

So, if you get in front of the right person, understand the system, follow your standards, have your workpapers in order – then what can go wrong? Plenty. Mike shared some of the most common errors he saw in reports during his time at the IRS. These include:

- Math – often from a failure to just check the math on the spreadsheets
- Date – be sure to double-check all dates related to the case
- Expertise
- Application of Discounts – make sure you can support your discount and apply it correctly
- Law Application – don't try to use case law to justify valuation positions
- Reconciliation Application
- Common Sense – don't choose a growth rate for your company that will exceed the U.S.
- Hypothetical Buyer and Seller
- Foreign Entity Assumptions
- Advocate for Client (Rule 702 Fed. Rules of Evidence and Testimony)
- Selective Use of Data
- Professional Judgment Over Data

The key to avoiding many of these errors is to double-check numbers, to show your data so that the IRS engineer can understand the assumptions and calculations you are making, and to make sure, as a valuation analyst, your own quality control is adequate.

Mike highly recommends a third party review the work product not only for technical correctness, but also for readability. A third party independent of the work product and familiar with the anticipated audience (US Tax Court, Appeals, IRS examination) can significantly improve the quality of the report.

By Eva M. Lang, CPA/ABV, ASA
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Mike Gregory, ASA, AVA, MBA, PE, has worked for the Internal Revenue Service as an engineer and business valuer, manager, operations team lead, acting district director, and territory manager. He has dealt with tax and valuation issues and has mediated disputes between the IRS and taxpayers within the IRS management and other venues. Mike worked on the restructuring of finance at the IRS and mediated budget and management issues. He has conducted mediations for the IRS since 2000 and within the Minnesota court system since 2004.

Does the Sum of the Parts Equal the Whole?

The proper application of control premiums and discounts for lack of control requires an understanding of the relationship between the two. Equally important is how they correspond to a business entity's total equity value (assumed in this article to be 100 percent control value) using the fair market value standard.

Under fair market value, a basic premise of business valuation is that the value of all fractional interests may not add up to total equity value. This is certainly the case, and rarely disputed, where a company's common equity is divided among five 20 percent ownership interests. In the simplest case, each of the five 20 percent interests would be valued the same. Each would constitute a non-controlling interest. The sum of five non-controlling interests, valued separately, do not add up to the 100 percent total equity control value.

It is less clear to many users of business valuation reports when the total equity value is comprised of at least one controlling interest within the company's common equity structure. Assume as an example a common equity structure of a single 55 percent controlling interest and three 15 percent non-controlling interests. Users of business valuation reports may think that the sum of these four separate common equity interests should equal total equity value. Such a conclusion requires that the 55 percent interest, in effect, include a "premium" for control equivalent to the total discounts accorded the three 15 percent interests for the lack of control inherent in each. Often, the very same arguments that are presented as substantiation for validating discounts for lack of control are applied in the opposite direction as merit for control premiums.

A basic example illustrates the flaw in this interpretation. Assuming a $5,000,000 total equity value, the 55 percent interest would be worth $2,750,000. As the base level of value is presumed to be controlling, no further premium is generally required for the control attribute.

If we assume that each of the three 15 percent interests are worth $750,000 on a controlling interest basis, it is necessary to apply a discount for lack of control to "convert" the value from controlling to non-controlling. For illustrative purposes, assume a discount for lack of control at 30 percent, which results in a value of each non-controlling 15 percent interest of $525,000.

The sum of the value of 55 percent interest and the three 15 percent interests is then $4,325,000. This total is $675,000 or 13.5 percent lower than the assumed total equity value.

If, as critics argue, the $675,000 difference is added to the value of the 55 percent interest so that the total value for all interests then equals $5,000,000, an additional 24.5 percent control premium is required to be applied to a value that is already deemed to be on a controlling interest basis. Moreover, the total percentage control premium, had the 55 percent interest been valued originally on a non-control value, assuming again a 30 percent discount for lack of control, is a whopping 78 percent!

The dynamics of any buyer, financial or otherwise, purchasing a control feature at a 78 percent premium is unlikely. Evidence of live transactions and the levels of acquisition/control premiums (e.g., Mergerstat) suggest significantly lower premiums. Adding additional weight to counter agreements is the deemed sale price value of the 55 percent interest. Whether a buyer of an equity interest is willing to pay a premium beyond his or her portion of any sale proceeds due is always case- and fact-specific. In the instant case, the buyer would receive no more than $2,750,000 if the 55 percent interest were later sold for the $5,000,000 total equity value. Presumably, this would be a major factor in his or her purchase decision.

Expert Tip

The discount for lack of control applied to non-controlling equity interests wil usually not correspond to a premium for control applied to a controlling interest in the same company.

The issues addressed herein are even more egregious in capital structures where only one to two percent of total equity constitutes all of the controlling interests of the entity, e.g., family limited partnerships. Such cases would require "super premiums" be added to controlling interests to attain the result of all fractional interest values equaling total value. Such super premiums are non-sensical and invalidate the premise that the sum of the parts always equals the whole.

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FEATURED CASE

ESTATE OF WIMMER V. COMMISSIONER

CITATION:
ESTATE OF GEORGE H. WIMMER, DECEASED, GEORGE W. WIMMER, PERSONAL REPRESENTATIVE, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

T.C. Memo. 2012-157, Docket No. 26540-07,
Filing date June 4, 2012, Judge Elizabeth Crewson Paris

OVERVIEW

The Tax court was tasked with determining if gifts of limited partnership interests transferred by the Decedent between 1996 and 2000 qualified for the Federal gift tax annual exclusion under § 2503(b).

TAKEAWAY

Because the general partners followed their fiduciary duty and the partnership agreement, gifts of limited partnership interests in a family limited partnership were gifts of present interests, thereby qualifying them for the Federal gift tax annual exclusion and were not includable in the Decedent's estate.

THE FACTS

In 1996, George H. Wimmer ("Mr. Wimmer" or the "Decedent") together with his wife, each acting as trustee of their individual trusts, formed the George H. Wimmer Family Limited Partnership, L.P. ("WFLP" or the "Partnership"). The Partnership was created for several stated reasons, including increasing the wealth of the partners and transfer assets to younger generations through the gift tax exclusion without fractionalizing the assets. Although the certificate of limited partnership was not filed until March 1997, the partnership agreement was executed on June 27, 1996. WFLP was funded in 1996 with dividend paying common stock and no additional funding was contributed during WFLP's history.

During every year between 1996 and 2000, Mr. Wimmer gifted limited partnership interests to relatives and trusts for the benefit of relatives. The transferred interests were subject to onerous transfer restrictions, including requiring unanimous consent of the general and limited partners to be admitted as a substituted limited partner.

Because WFLP's primary asset was a dividend paying stock, the Partnership received dividends. WFLP then distributed all of its dividend income (net of expenses) pro rata to its partners.

DISCUSSION

The parties disagreed as to whether the gifts of limited partnership interests were present interests or future interests. If the interests were present interests, they qualified under § 2503 as gifts. If they were not present interests, they were includable in the Decedent's estate.

The court ruled that the limited partnership interests themselves were not present interests. However, relying on *Calder v. Commissioner,* 85 T.C. 713, 727-728 (1985), the court used a three pronged test to determine if the income generated by the Partnership satisfied the criteria to be a present interest under § 2503:

1. Will the Partnership generate income?
2. Will some portion of that income flow steadily to the donees?
3. Can that portion of income distributed be readily determined?

Because WFLP owned a dividend paying stock and because dividends were received quarterly in every period during which gifts of limited partnership interests were gifted, the Partnership satisfied the first prong.

The court determined some portion of income would flow to the donees due to the fiduciary duty of the general partners to the limited partners. When combined with the Partnership's sole asset being a dividend paying stock and its stated intent to use the gift tax exclusion to transfer interests to younger partners, the court found the fiduciary duty of the general partners satisfied the second prong. In particular, the court noted the distributions to satisfy the tax liabilities associated with entity income for various limited partner trusts met the fiduciary duties of the general partners.

Finally, because the stock was publicly traded and because it distributed income quarterly, partners could reasonably determine estimated quarterly and annual income. As a result, the court ruled for the estate and determined the transfers of limited partner interests were present interests. Therefore, the gifts of present interests qualified for the federal gift tax annual exclusion under § 2503(b) and were not includable in the Decedent's estate.

CONCLUSION

Strict adherence to fiduciary duty and the terms of the partnership agreement resulted in a favorable determination for the estate.

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