

IRS Vantage Point:

LESSONS FROM THE IRS FOR THE PRIVATE SECTOR

Introduction

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Mr. Knapp has nearly two decades of business valuation experience. Previously, he held various valuation roles in the private sector and as a lead valuation analyst at the Internal Revenue Service (IRS). During his career, Mr. Knapp has assisted and educated business owners, attorneys, and auditors regarding the valuation of closely-held business interests. Mr. Knapp's valuation analyses and reports have been prepared for purposes of estate and gift tax, charitable contributions, litigation support, and transaction advisory. He has successfully defended his opinions of value at the IRS appeals level while in the private sector and with the Service.



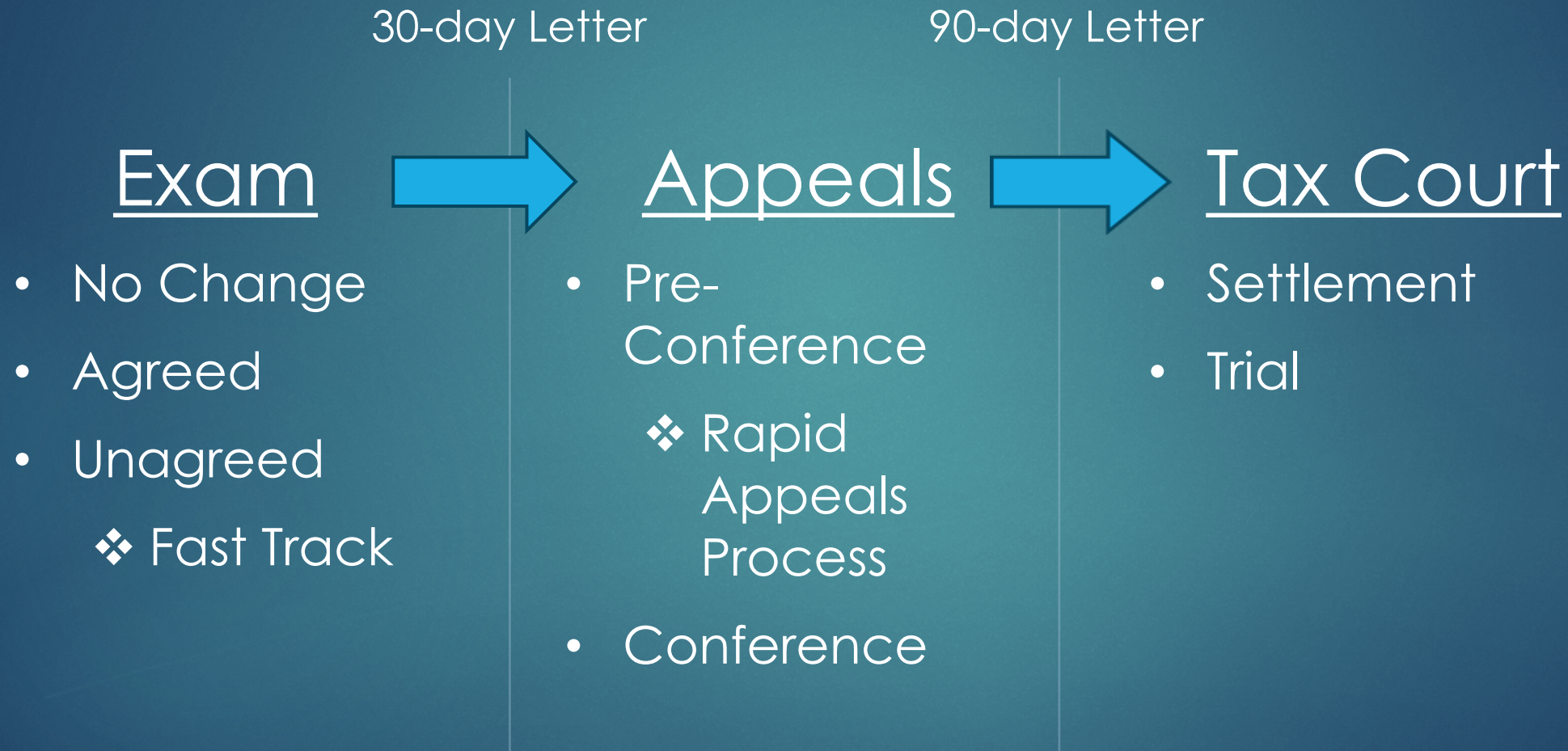
Introduction

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Audit Process

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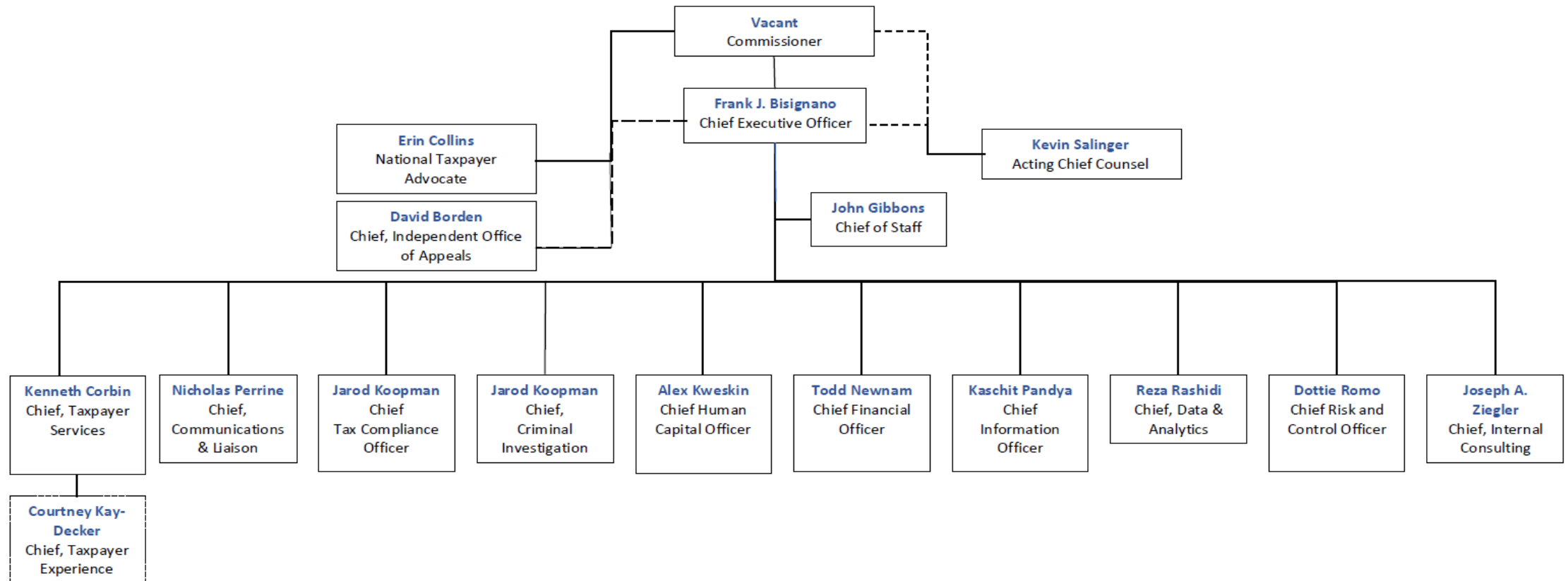
Presentation Overview

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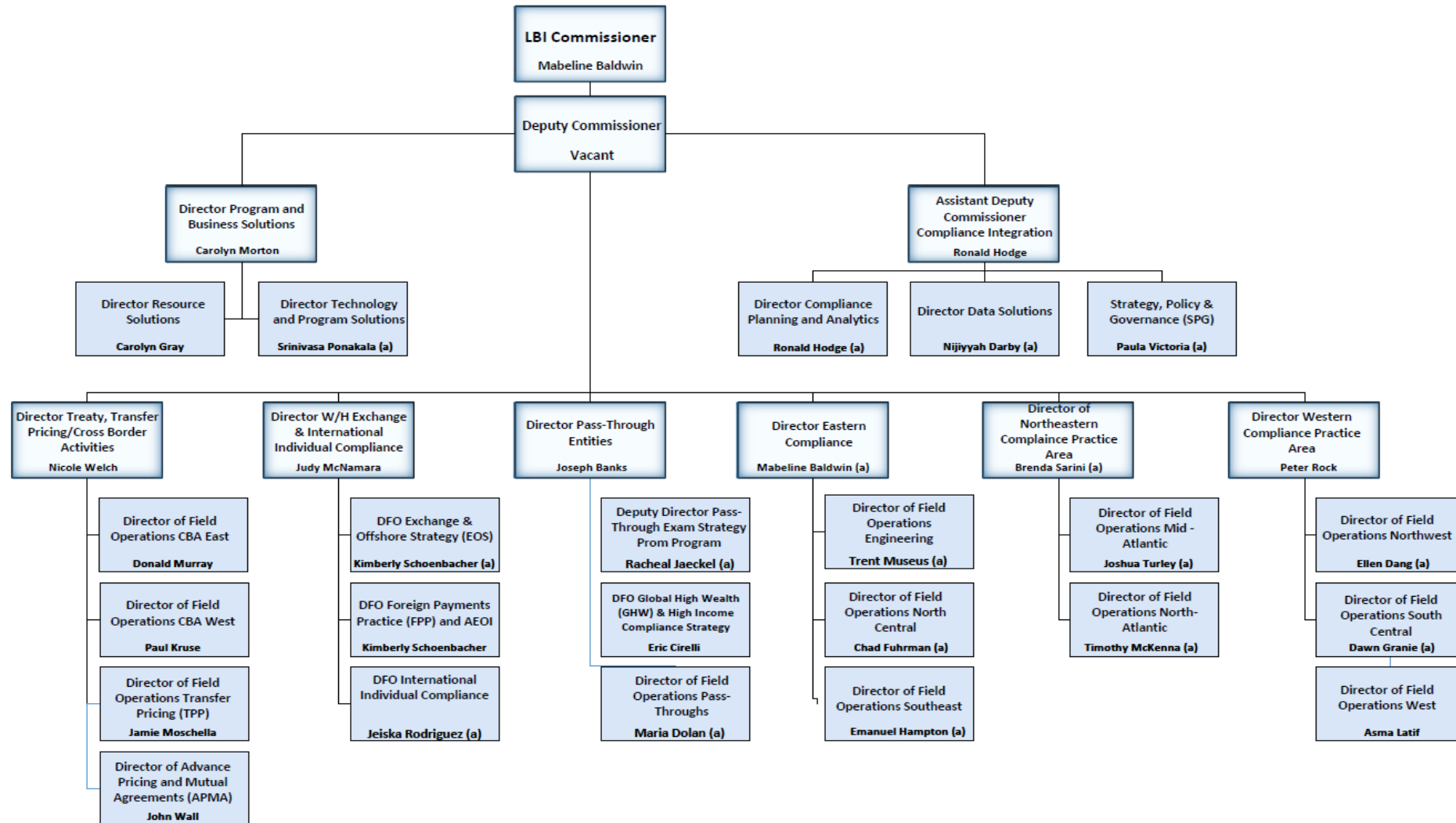
- ▶ Organization
- ▶ Internal Revenue Manual (IRM)
- ▶ Referrals and Issues
- ▶ Case Examples
- ▶ Red Flags

IRS Organization Chart

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE Organization and Top Officials



LB&I Organization Chart



Valuation Assistance

- ▶ Valuation services provided by:
 - ▶ Engineering
 - ▶ Art Appraisal Services
 - ▶ External Appraisers
- ▶ Estate and Gift (E&G) attorney referral
 - ▶ Specialist Referral System (SRS)
 - ▶ Program Analyst in Engineering compiles and reviews
 - ▶ Engineering managers receive list of referral requests
 - ▶ Managers send out list to appraisers on their team

Referrals and Issues

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- ▶ Estate and Gift (E&G) attorney or Revenue Agent (RA) referral
 - ▶ Valuation analyst accepts case referral
 - ▶ Reaches out to E&G attorney or RA to request the valuation report
 - ▶ If an issue or issues are discovered to pursue, the review continues
 - ▶ Supporting documents can be requested from the examiner
 - ▶ If these items are not in possession, an Information Document Request (IDR) is issued

Information Document Request (IDR)

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- ▶ Timeline and Enforcement Process
 - ▶ Provide a draft IDR and discuss with the taxpayer
 - ▶ A response date is usually agreed, final IDR issued
 - ▶ If no response, can extend or start enforcement process
 - ▶ Delinquency Notice
 - ▶ Pre-Summons Letter
 - ▶ Summons

Reviewing a Valuation Report

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- ▶ In reviewing a business valuation and reporting the results of that review, an appraiser should:
 - ▶ Form an opinion as to the adequacy and appropriateness of the report being reviewed, and
 - ▶ Should clearly disclose the scope of work of the review process undertaken.
- ▶ In the event of a disagreement with the report's factual representations, underlying assumptions, methodology, or conclusions, an appraiser should conduct additional fact-finding, research, and/or analyses necessary to arrive at a credible value conclusion.

Work Product

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- ▶ The valuation report may be in memo format or another format
- ▶ For a memo, the following headings “must” be included:
 - ▶ Issue
 - ▶ Facts
 - ▶ Applicable Law
 - ▶ Taxpayer’s Position
 - ▶ Argument or Analysis
 - ▶ Conclusion
- ▶ An expert report would be suitable for submission to a court
 - ▶ Common types are an appraisal or valuation

Issue Resolution Steps

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- ▶ Communicating a clear understanding of the taxpayer's methodologies and legal and factual arguments.
- ▶ Explaining to the taxpayer why their value is incorrect or unsupported.
- ▶ Considering the acceptable range of values for resolution purposes.
- ▶ Proposing the value to the taxpayer that is the most probable and supportable.

Unresolved Issues

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- ▶ After issuance of a memo, you might receive a response from the taxpayer's representative. This can include a response from the taxpayer's valuation firm.
- ▶ Appraiser can submit a rebuttal to the response.
- ▶ If the taxpayer still disagrees with the proposed changes, their rep will submit a formal written protest to request an Appeals conference.
- ▶ Appraiser submits Form 886-A as unagreed to the examiner and closes the issue out.
- ▶ Appraiser will support and present exam's position in Appeals Pre-Conference.

Case 1 Example

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Charitable Contribution and Stock-Based Compensation (409A)

- ▶ Subject Interest = Same class of common stock
- ▶ Valuation Date = February 3 and February 20, same year
- ▶ FMV for stock-based compensation = \$10 per share on Feb. 3
- ▶ FMV for charitable contribution = \$25 per share on Feb. 20
- ▶ Difference in valuation reports
- ▶ Documents provided by taxpayer's rep
- ▶ Exam
- ▶ Appeals
- ▶ Tax Court

Case 1 Example (continued)

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CONDUCT:

An appraiser must perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interests.

An appraiser:

- must not perform an assignment with bias;
- must not advocate the cause or interest of any party or issue;
- must not agree to perform an assignment that includes the reporting of predetermined opinions and conclusions;
- must not misrepresent his or her role when providing valuation services that are outside of appraisal practice;¹⁶
- must not communicate assignment results with the intent to mislead or to defraud;
- must not use or communicate a report or assignment results known by the appraiser to be misleading or fraudulent;
- must not knowingly permit an employee or other person to communicate a report or assignment results that are misleading or fraudulent;
- must not engage in criminal conduct;
- must not willfully or knowingly violate the requirements of the RECORD KEEPING RULE; and
- must not perform an assignment in a grossly negligent manner.

Case 1 Example (continued)

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“I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. section 330(c)”

Case 1 Example (continued)

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Part IV Declaration of Appraiser—See instructions.

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this Form 8283 may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. 330(c).

**Sign
Here**

Appraiser signature

Date

Appraiser name

Title

Business address (including room or suite no.)

Identifying number

City or town, state, and ZIP code

Case 2 Example

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Auto Dealership for Estate Tax Purposes

- ▶ One piece of a large estate
- ▶ 100% controlling interest
- ▶ DLOM of 5%
- ▶ Blue sky method
- ▶ Dealership acquired less than 10 months after DOD
- ▶ Exam
- ▶ Meeting
- ▶ Resolution

Car Dealership - Estate Tax	
Average of Adjusted Pretax Earnings	
Blue Sky Method	
Fiscal Year	Adjusted Earnings
2019	\$1,000,000
2020	5,000,000
2021	6,000,000
3-Year Average	\$4,000,000
Blue Sky Multiple	5.0
Intangible Value (Blue Sky)	\$20,000,000
Plus: Tangible Asset Value	\$20,000,000
Market Value - Total Assets	\$40,000,000
Less: Total Liabilities	(\$5,000,000)
Market Value - Equity	\$35,000,000
Discount for Lack of Marketability	5.0%
Fair Market Value - Equity	\$33,250,000

Case 2 Example (continued)

Car Dealership - Estate Tax	
Average of Adjusted Pretax Earnings	
Blue Sky Method	
Fiscal Year	Adjusted Earnings
2020	5,000,000
2021	6,000,000
2-Year Average	\$5,500,000
Blue Sky Multiple	5.0
Intangible Value (Blue Sky)	\$27,500,000
Plus: Tangible Asset Value	\$20,000,000
Market Value - Total Assets	\$47,500,000
Less: Total Liabilities	(\$5,000,000)
Market Value - Equity	\$42,500,000
Discount for Lack of Marketability	5.0%
Fair Market Value - Equity	\$40,375,000

Case 2 Example (continued)

Case 3 Example

Equipment Rental Company for Estate Tax Purposes

- ▶ 706 valuation report - 2021
- ▶ 709 valuation report - 2018
- ▶ Same appraiser
- ▶ Shareholders' agreement
- ▶ Put option
- ▶ Specific risk
- ▶ Noticeable growth in revenue and earnings
- ▶ Nearly identical values

Case 3 Example (continued)

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Equipment Rental - Gift Tax Calculation of Discount Rate 2018		Equipment Rental - Estate Tax Calculation of Discount Rate 2021	
20-Yr Treasury Yield	2.00%	20-Yr Treasury Yield	2.00%
Equity Risk Premium	5.00%	Equity Risk Premium	5.00%
Size Risk Premium	5.00%	Size Risk Premium	5.00%
Specific Risk Premium	3.00%	Specific Risk Premium	10.00%
Discount Rate	15.00%	Discount Rate	22.00%
Growth Rate	3.00%	Growth Rate	3.00%
Capitalization Rate	12.00%	Capitalization Rate	19.00%
Earnings	\$3,000,000	Earnings	\$4,800,000
Freely Traded Value of Equity	\$25,000,000	Freely Traded Value of Equity	\$25,263,158
Discount for Lack of Marketability	30.00%	Discount for Lack of Marketability	30.00%
Fair Market Value of Equity	\$17,500,000	Fair Market Value of Equity	\$17,684,211
Fair Market Value of a 1.0% Interest	\$175,000	Fair Market Value of a 1.0% Interest	\$176,842

Case 4 Example

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Related Party Transaction and Gift Tax

- ▶ Transactions between siblings
- ▶ Transfers for gift tax purposes
- ▶ No valuation reports
- ▶ Global high wealth division
- ▶ Arm's length concept ignored
- ▶ Prior gift tax transfer
- ▶ Referral to E&G attorney

Valuation Red Flags

- ▶ Provided by management projections
- ▶ Tax affecting on pass-through entities
- ▶ Investment value and not FMV
- ▶ Unsupported specific risk premium
- ▶ Inconsistent valuations
- ▶ Discounts based on purpose

Key Takeaways

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- ▶ Make sure the valuation firm you engage...
 - ▶ Understands the relevant sections of the IRM and other IRS literature
 - ▶ Knows how to work professionally with the IRS and resolves any issues at the exam level
 - ▶ Is not audited regularly
 - ▶ Is independent and not biased toward the purpose. Be consistent!

Questions?



Thank you!