DLOMs and the IRS

An E-Book to accompany Part Five of my book Business Valuations and the IRS: Five Books in One,

by Michael A. Gregory

Background

The focus of this abbreviated commentary is on the DLOM for federal tax purposes.

After completing a controlling valuation on an entity, conventional appraisal theory and standards would recommend applying a Discount for Lack of Control (DLOC) and a Discount for Lack of Marketability (DLOM) to a minority interest as presented below.

The IRS standard of Fair Market Value (FMV) is "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

(c) 2018 Birch Grove Publishing. All rights reserved.

After a business valuer completes a valuation on the entity the business valuer needs to determine a DLOC and a DLOM adjustment for a minority interest holder. The IRS has found that after a qualified control appraisal determination by a qualified appraiser many times limited attention was applied by the appraiser when determining a DLOM. The methods to determine a DLOC on the other hand are very well developed and generally there are not issues with the determination of a DLOC by the IRS. That is not generally the case with respect to a DLOM. In many instances the determination of a DLOM may appear to the IRS as being arbitrary with "boilerplate" generic commentary and selecting a DLOM to the potential advantage to the appraiser's client regardless of the facts. As the IRS began to consistently make adjustments to these DLOM's it became apparent that the IRS was inconsistent in its application to the issue as well.

Michael Gregory, as a territory manager in the IRS that headed up business valuation nationally, requested that a team be formed to address this problem of inconsistency. A team was formed and Michael Gregory championed this team. The result was Discount for Lack of Marketability Job Aid for IRS Professionals dated September 25, 2009. This was released to the public on August 21, 2011. However, many things changed between 2009 and 2011. In 2013 Michael Gregory went back to the original modelers and essentially critiqued the Job Aid and updated the commentary to current events with his book Discount for Lack of Marketability and the IRS. This book has been significantly expanded and updated as one component of his new book Business Valuations and the IRS: Five Books in One. Mike's latest book is specifically for business appraisers, expert witnesses, and those who work with the IRS regarding business valuations. This publication aids the reader in understanding classification, the IRS review processes and structure, and how to resolve conflicts with the

IRS. It also covers how the IRS looks at valuing non-controlling interests in S-corps, valuing reasonable compensation, and the discount for lack of marketability so that you can take appropriate actions. This text also ties back to the IRS Job Aids on S-Corp valuations and Reasonable Compensation and other sources updated to today.

However, the focus on this commentary is on DLOM's and the IRS. This text is not oriented towards how to develop a DLOM. For current sources you are directed to Discount for Lack of Marketability Guide and Toolkit by Hitchner et al, BVR's Guide to DLOMs by John Stockdale or other specific author's models. Rather this commentary is oriented towards, which of the models may be accepted by the IRS and which may not and if audited how to work with the IRS to resolve issues.

How to Use the IRS Job Aid on DLOMs

The commentary that follows provides you with insights related to the original Job Aid on DLOMs, updates to the Job Aid, and how to work with the IRS to resolve issues related to DLOMs.

Download the IRS Job Aid on DLOMs and read it. Why? It has a wealth of information to help you understand how the IRS addressed this issue and what you may want to consider as you develop a DLOM. Read the executive summary and introduction to obtain a flavor of why it was written and understand that it was not written for you as a business valuer, but for the IRS business valuer working at the IRS. Note the 33 factors that the Job Aid identifies that can have an impact on the DLOM.

Of course the IRS uses the 9 factors identified in the now famous Mandelbaum Case, but the IRS went further and asked all of its valuers what were other factors they deemed to be important? These were included in this list of 33 factors. Also included are 17 initial pro-forma Information Document Requests (IDRs) from the IRS. This tells you what the IRS is going to question regarding your development of your DLOM. These questions should have been answered in your appraisal. I would recommend never accepting pro-forma IDRs.

One of the IRS 13 divisions, Large Business and International (LB&I) division, has a process you may want to consider regarding any IRS requests. This is documented in a Directive to all LB&I employees. The directive employs a 12 step process that requires discussing preliminary IDRs first. This process can save significant time and resources on your part if you can convince the IRS agent to use this process.

Regardless of which division you are working with at the IRS you may want to politely request the use of this directive on the audit. With the IRS reorganization in 2000 the IRS divisions have had limited interactions with each other. As a result other divisions are not aware of this directive, but if an IRS agent is requested to use it, this has been received well in other divisions at the IRS too.

The DLOM Job Aid also presents several key sections that can help you understand how the IRS approaches the DLOM issue. These are:

- How IRS Valuers Should Approach Issue As a Reviewer
- How IRS Valuers Should Approach Issue As a Valuer
- Provides sample report language
- Detailed strengths and weaknesses of most common approaches
- and other information that I believe you would find helpful.

The most common approaches were broken up into four broad categories. These are:

- Benchmark Approaches
- Securities Based Approaches
- Analytical Approaches
- Other Approaches

These approaches include 18 commonly used methods and 2 more in the appendices. The methods were chosen based on what the IRS found on audits.

These were the methods found under each approach with a

- + for generally accepted
- - for generally not accepted
- 0 for neutral in terms of acceptance by the IRS
- NA - for not applicable

Benchmark Approaches

- Restricted Stock Studies +
- Pre-IPO Studies -
- Restricted Stock Equivalent Analysis NA
- Cost of Flotation: About to go Public Only +
- Mandelbaum Factors, Judge Laro 1995: Good first step with 9 – 10 factors +

Securities Based Approaches

- Long-Term Equity Anticipation Securities (LEAPS) Robert Trout 2003, Ronald Seaman 2005 +

- The Longstaff Study, Journal of Finance, December 1995 +
- Note VFC DLOM Calculator from Vianello: Consider +
- Uses Longstaff Mathematics and Actual Data
- Considers Probability of Sale Duration and Volatility
- The Chaffee Study: 0 Possible Check
- Bid-Ask Spread Method to Determine DLOM –
- Later Comments on the Finnerty Model +

Analytical Approaches

- Karen Hopper Wruck: NA
- Hertzel and Smith: NA
- Bajaj, Denis, Ferris and Sarin: consider – IRS concerns
- Ashok B. Abbott: stay abreast

Other Approaches

- QMDM (Christopher Mercer) + possible check
- NICE (William Frazier) + only income approach
- NERA (David Tabak) + complex
- Partnership Profiles (Partnership Spectrum) +FLPs
- Public versus Private P/E Ratios in acquisitions (MergerStat) -

- In Appendix:
    - John Finnerty +
    - FMV Opinions + first of three variables
    - Pluris + first of two variables

From this analysis various approaches were recommended.

Updates to the Job Aid and Recommendations

Since the Job Aid was released to the public many of the methods have changed over time. These were critiqued in Mike's book Discount for Lack of Marketability and the IRS. Since that time there have been additional changes and two items should be brought to your attention. The two new items are:

VPS DLOM Guide and Toolkit

- Jim Hitchner, Jim Alerding, Josh Angell, Kate Morris
- Take Into Account 17 methods – 2017

VFC DLOM Calculator by Marc Vianello

- Probability based time
- Probability based price volatility
- You Tube video

How to Work with the IRS to Resolve Issues Related to DLOMs

Having worked for the IRS for 28 years, with the IRS in the private sector for over 6 years and having worked with neuroscientists on conflict resolution issues over the last four years, I want to share some information at a high level with you related to the IRS and resolving issues. This involves four stages:

Develop a Relationship

Our typical reaction to being questioned or challenged is to respond negatively. This is natural. However, in anticipation of this reaction it is very important to de-escalate this emotion, remain calm, remain professional, work on communication to have a conversation by listening, moving towards a discussion that may lead to open dialogue related to understanding interests related to your negotiation on valuation. However, as motivated as you may be to move right into the negotiation neuroscience suggests developing a relationship first.

To do this will take some research. Ask who you will be meeting with. Learn as much as you can about the participants from social media and other contacts. Come to the first call or first meeting asking if the other party would be willing to spend a few minutes so we could get to know each other a little bit first in order to develop an element of trust. From Mike's books The Servant Manager, Peaceful Resolutions and Business Valuations and the IRS, Mike offers detailed ideas on how to approach this process with real world examples.

Listen to Understand

Listening to understand means asking open ended questions, paraphrasing what the other party stated, summarizing and not offering your opinion or solutions. By listening to the other party, you can work to uncover interests or concerns and you may very well discover elements that the other party has misunderstood or may not be aware of as part of the process. Since 2010 the IRS has cut its training budget by over 90%. IRS employees are not receiving the education and training that they need. Be open minded and listen to where they are coming from. Listen to understand so that later you may be able to help educate the participants at the IRS.

Educate to Inform

Many appraisers have been told not to be an advocate for their client, but for their work. In this instance, I believe being an advocate for your work is misguided. Rather, you need to be there to educate the IRS on what you did and why very similar as to how you would educate a judge on a case. You don't educate the judge as if it were a debate. You educate a judge by presenting information in such a way as to demonstrate your professionalism, your integrity, your ability to explain complex elements in simple terms and by gaining the trust of the judge. Keep this in mind relative to your interactions with the IRS. You are there to educate the IRS at this stage.

Negotiate Focus on Interests

You are now ready to begin the process of a negotiation. Mike offers weekly blog commentary related to this topic with the IRS. Valuation is an inexact science. It is actually an art as well as a science. You need to be able to tell a story that makes sense to a third party. You need to negotiate with the IRS by understanding their interests. You need to understand who the decision maker is. The decision maker is not the IRS business valuer. The initial decision maker is the agent or the estate and gift tax attorney. The ultimate decision maker is the manager of the agent or the manager of the estate and gift tax attorney.

Keep that in mind relative to your discussion of interests on who you are trying to impact related to your valuation issue. This may take several iterations to ultimately have your client reach the right parties as the decision maker on the issue. The key is to uncover interests. You as the valuer may not be in the final meetings, but your client may very well be meeting with the decision maker after both sides have brought their valuers to the initial meeting(s).

Recommendations

These are the models that are most likely to be accepted by the IRS depending on the facts and circumstances in your situation.

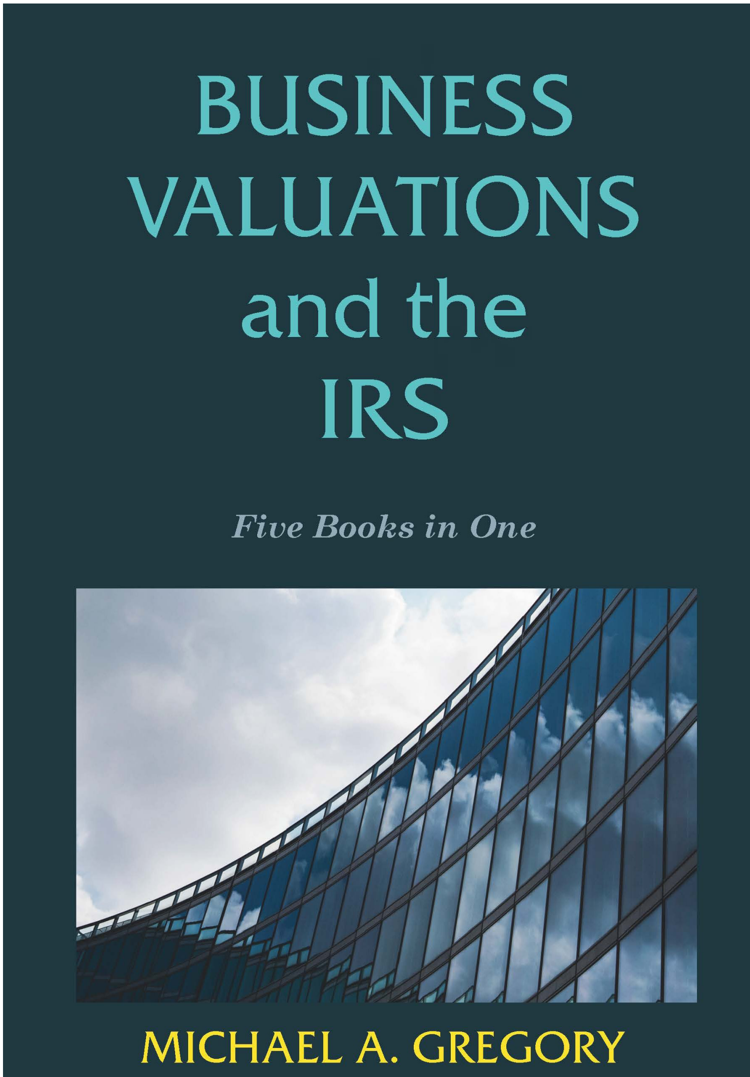
- Restricted Stock Studies +
- Cost of Flotation: about to go public only +
- Mandelbaum factors, Judge Laro 1995: good first step with 9 – 10 factors +
- Long-Term Equity Anticipation Securities (LEAPS) Robert Trout 2003, Ronald Seaman 2005 +
- The Longstaff Study, Journal of Finance, December 1995 +
- Finnerty model +
- Note VFC DLOM Calculator from Vianello: consider +
- <u>Ashok B. Abbott: stay abreast</u>
- QMDM (Christopher Mercer) + possible check
- NICE (William Frazier) + only income approach
- NERA (David Tabak) + complex
- Partnership Profiles (Partnership Spectrum) +FLPs
- FMV Opinions now Stout + first of three variables
- Pluris + first of two variables

As an overview this is a recommended approach for having your DLOM analysis accepted by the IRS.

- Obtain the DLOM Job Aid and use it
- Use Three Approaches and Reconcile Them
- Appropriate Restricted Stock Studies and 33 Factors
- Use a data source – private placements such as Pluris or Stout raw data and appropriate 33 factors
- Use a third approach that makes sense
- Reconcile the approaches taken to develop the final DLOM
- Work with the IRS on Business Valuation Issues
- Develop a relationship with the Estate Tax Attorney or Field Agent
- Work with the IRS Engineer or Business Valuer
- Elevate in management if needed
- Always be professional

If you are involved with the IRS on a DLOM or business valuation issue you can always contact Mike Gregory at 651-633-531 and at mg@mikegreg.com. He would more than happy to assist you with your concerns.

Watch for news about my coming book from BVR!



ORDER THIS BOOK from BVR

BUSINESS VALUATIONS and the IRS:

Five Books in One

by Michael A. Gregory

"The most comprehensive book ever written on business valuation and the IRS"

850 pages, hardcover; $399 from Amazon.com;
$249 from Business Valuation Resources

To order or to find more information about this book from BVR

(c) 2018 Birch Grove Publishing. All rights reserved.