

How to Conduct an S-Corp Valuation for the IRS Given IRS Internal Memorandums

An E-Book to accompany
Part Three of my book
[Business Valuations and the IRS:
Five Books in One,](#)
by Michael A. Gregory

Background

As a territory manager in the IRS responsible for business valuation issues throughout the country, I requested that a team be formed to address the problem of inconsistency on the application of tax affecting S-corps. A team was formed and I was named “champion” of the team. The team consisted of business valuers from the Large Business and International (LB&I) division of the IRS plus Estate and Gift (E&G) tax attorneys and litigating attorneys from the Small Business Self Employed (SBSE) division. Our team produced an internal white paper which received the approval of all four of the LB&I engineering territory managers and three of the five SBSE E&G territory managers which was used internally by the IRS business valuers. After I retired from the IRS and joined the private sector, through a FOIA request I obtained access to a modified white paper that only addressed

valuing non-controlling interests in S-Corps and removed a great deal of the original white paper when I worked at the IRS. In my book [How the IRS Values Non-Controlling Interests in S-Corps with job aid commentary by the original IRS champion](#) I critiqued the Job Aid and offered insights to help business valuers with the issue for federal tax purposes. That book was published in 2015. In 2017 another FOIA request was made to the IRS to obtain an internal memorandum on valuing non-controlling interests in S-corps. When that memorandum was obtained it cited a second memorandum. That too was requested via a freedom of information request in 2018. The bottom line is that SBSE as a matter of policy is asking LB&I Engineering (where the IRS business valuers are located) to supply a calculation without tax affecting. However, the valuer is also to consider Revenue Ruling 59-60 as well as the Job Aid on valuing non-controlling interests in S-Corps.

The Most Up To Date Information on BV and the IRS

My most recent book, [Business Valuations and the IRS: Five Books in One](#), critiques the Job Aid and brings the reader up to date on what a valuer needs to do to avoid an audit and what to do if the valuer's appraisal is audited by the IRS. This book is written specifically for business appraisers, expert witnesses, and those who work with the IRS regarding business valuations. This book 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 book also ties back to the IRS Job Aids on S-Corp valuations and Reasonable Compensation and all other sources up to the present.

The IRS Job Aid on Non-Controlling Interests in S-corps

To get you started, begin by downloading the [IRS Job Aid on Valuing Non-Controlling Interests in S-corps](#) and read it. Why? The Job Aid has a wealth of information to help you understand historically how the IRS addressed this issue and what you may want to consider as you develop a valuation for non-controlling interests in S-corps. 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 in particular the two examples and especially example 2, as well as the internal comments in the body on tax affecting. The second example indicates that you may need to modify the discount rate and the Discount for Lack of Marketability to take into account additional risks for a noncontrolling interest in an S-Corp.

Working with the IRS to Resolve Issues Related to S-Corps

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:

1. 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.

2. 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.

3. 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.

4. 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 and others. 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). If you are involved with the IRS on a business valuation issue you can always contact Mike Gregory at mg@mikegreg.com and at 651-633-5331. He would more than happy to assist you with your concerns.

Outline of the Topic with Helpful Links

Background

Focus on Non-Controlling S-Corp Job Aid – Intro to and Job Aid

IRS S-Corps and Job Aid Observations

IRS Memorandum S-Corporation Valuation

Procedures received November 18, 2017

Background IRS Memorandum S-Corporation Valuation

Procedures received January 4, 2018

Commentary for Your Consideration

Court Case Implications

Consider Valuation Approaches

Personal Observations

IRS Organization Then and Now

Management Philosophy

Three IRS Released Job Aids

“Valuation of Assets IRS” on Google

Released August 2011

[Discount for Lack of Marketability dated 9/2009](#)

Released May 2015

[Non-controlling Interests in S-Corporations dated 11/2014](#)

[Reasonable Compensation dated 11/2014](#) and [appendix](#)

[“Valuation of Non-Controlling Interests in Business Entities](#)

[Electing To Be Treated as S-Corporations for Federal Tax](#)

[Purposes: A Job Aid for IRS Valuation Analysts”](#)

Note Authors and Implications – LB&I Engineering and SBSE E&G

October 29, 2014

“This job aid is not Official IRS position and was prepared

for reference purposes only, it may not be used or

cited as authority for setting any legal position.”

Introduction

Identification of Property to be Value

Background and Approach

[Revenue Ruling 59-60](#) (Read Background and Definitions and

Eight Factors Again) ([Note Section 3.01](#) and dividend paying

capacity addressed not distributions consistent with an S-corp)

Additional Factors for Consideration

Public Market Data - C Corps

Shareholder's Agreement

Appropriate Tax Rates

Effective Average Rate is Between Zero and
Maximum Statutory Tax Rate

Note article: "[Individual Income Tax Rates and Shares, 2011](#)"

Adrian Dungan and Michael Parisi; Figure B 20%, 24% and 23%

Note Article: "[Average Effective Federal Corporate Tax Rates](#)" US Treasury Department 2016 – Overall 22%

Now need to consider the Tax Cut and Jobs Act of 2017

Universe of Hypothetical Buyers

Hypothetical Seller

Hypothetical Sale

Additional Factors for Consideration

Identify the Most Important Factors

Joint Effort LB&I and SBSE

[Revenue Ruling 59-60](#)

[IRC 1362\(a\)](#) *Small Business Elect S Corp*

[IRC 1371\(a\)](#) *Rules*

Reflect Risks

Background on S-Corps – Gross Case

Identify the Most Important Factors

Evidence-Based Valuation Analysis

A View from the Tax Court

Appendix B:

[Gross T.C. Memo 1999-254](#), *aff'd. 272 F.3d 333 (6th Cir-cuit) 2001*, *cert denied 537 US 827 (2002) (Corp)*

[Wall TC Memo 2001-75](#) *(Corp)*

[Heck T.C. Memo 2002-34](#) *(Corp)*

[Adams T.C. Memo 2002-80](#) *(Corp)*

[Dallas T.C. Memo 2006-212](#) *(Corp)*

[Giustina TC Memo 2011-141](#) *(Limited Partnership)*

[Gallagher TC Memo 2011-244](#) *(LLC)*

A View from Academia

Merle M. Erickson and Shing-wu Wang, [Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations](#),

The Accounting Review, Vol. 82, No. 2, pp 359-387 (2007)

Premiums for [Control 338 \(h\)10](#) Acquisitions

Theory Based Valuations – Not Tested

Weighting of Factors and Approaches:

Assessment and Synthesis

Example 1: The Tax Status of the Electing S Corporation

Example 1 Six Broad Questions:

Gross case met this criteria – don't tax affect

Example 2 Cost of Capital and DLOM

Greater Risk in Limited Ability to Raise Capital

Shareholder Agreement Restrictions

Increase DLOM and Increase Cost of Capital Taking

Into Account Pool of Likely Buyers

Possibly No Adjustment Here Depending on the Facts of the Case

Summarizing Factors to Consider

The Size and Composition of the Pool of Hypothetical Buyers

The Economic Interests of the Hypothetical Seller

The Actual Revenues Available to and the Actual Expenses to be

Paid by the Entity that has Elected to Be Taxed as an S Corp

The Availability at the Entity Level of Equity and Debt

The Likely Holding Period of the Transferred Interest

“With respect to the question of pass-through taxation, no entity level tax should be applied in the valuation analysis of a non-controlling interest in an electing S Corporation, absent a compelling demonstration that independent third parties dealing at arms-length would do so as part of purchase price negotiation.”

Personal income taxes of a potential interest buyer “are not relevant.”

Highlights of 1120S Corporations

Requirements to be an S-Corp

Disadvantages of an S-Corp

[Tax Affecting S Corporations: It's Not a Matter of Whether. It's a Matter of When by Alan Zipp, BV Update Vol. 23, No. 12, December 2017 and responses to the article](#)

Fair Market Value is a legal standard of value contained in the tax law and is required for all tax valuations.

IRS Memorandum

IRS Memorandum for Estate and Gift Employees, and

Engineering Business Valuation Specialists
Dated 3/12/2013
Received 1/3/2018 via FOIA Request

Title of IRS Memorandum

IRS Memorandum for Estate and Gift Employees, and
Engineering Business Valuation Specialists
Dated 4/8/2015
Received 11/18/2018 via FOIA Request

E&G Policy Memorandum

Dated April 8, 2015

Michael Gregory obtained November 18, 2017 via a
Freedom of Information Act (FOIA) request

Authors: Director of Engineering LB&I and Director of Policy SBSE

Subject: S-Corporation Valuation Procedures

Key Points: "In valuing the subject entity, if an income
approach is used please assume a zero percent tax
rate in the subject entity's earnings stream."

Report should clearly state, "a zero percent tax rate
was used at the request of the Examiner."

E&G Policy Memorandum

However, the valuer is "to consider" the IRS Job Aid that
discusses the valuation of non-controlling interests
in S Corporations and Revenue Ruling 59-60

Implication of the IRS Memorandum

Ensure pre-tax cash flows are discounted with pre-
tax tax rates. [Cost of Capital: Applications and Exam-
ples 5th edition](#) chapter 37 for appropriate way to tax
affect discount rate. Not simply dividing by (1-T)

Consider the impact on the Discount for Lack on Marketability
(DLOM) consistent with the Job Aid on Non-Controlling Interests.

Consider using the 33 factors in the Job Aid on DLOMs
Consider the seven factors on slide Disadvantages of an S-Corp
Consider the impact on the Discount for Lack of Control (DLOC)

Fannon Sellers Commentary

Explore the Data
Size Matters
Facts Matter

Fannon Sellers Paper

[Valuation of Pass-Through Entities: Looking at the Bigger Picture, 2012 American Taxation Association Midyear Meeting: JLTR 13 Feb 201](#)

Treharne

*Introduces concept of a C-Corp valuation adjustment
The reinvestment of retained earnings may
or may not contribute to value
Contribution of S-Corp: because the shareholder avoids
paying the double taxation with C-Corp dividends*
See ["A Hands on Approach to S-Corporation and Pass-Through Entity Valuations"](#) by Paul R. Hyde and Shawn M. Hyde, IBA [Business Appraisal Practice, First Quarter 2010](#) Contact me or Guy Sanschagrin for a Workbook Associated with this article

Van Vleet

What About Implications Related to Control Value?
Merle M. Erickson and Shing-wu Wang, [Tax Benefits as a Source of Merger Premiums in Acquisitions of Private Corporations](#), The Accounting Review, Vol. 82, No. 2 , pp 359-387 (2007)
For control value S Corps have had values of 12% to 17% higher from Code Section 338 analysis

What About Implications Related to Control Value?
["The Moderating Effects of Acquisition Premiums in Private Corporations: An Empirical Investigation of Relative S Corporation and C Corporation Valuations."](#) By James A. DiGabriele

*Results of Estate Audits in 2016**Chances of an Audit by the IRS Personal Observations**Personal Observations*

Look at subject

Look at industry

Look at hypothetical buyers and sellers

Consider alternatives to tax affecting and appropriate risk

Discount rate reflects S-Corp and non-controlling risks

Pre-Tax discount rate with pre-tax cash flows adjusted properly

DLOM

DLOC

Is there a material difference in value? Maybe/Maybe not

Make a professional determination

*Personal Recommendation**Consider Implications of the Tax Cut and Jobs Act 2018*

[“How the New QBI Deduction Impacts the Hypothetical Buyer and Seller”](#) by Mark O. Dietrich and Kevin R. Yeanoplos in the

Business Valuation Update, Vol. 24, No. 3, March 2018

8 rules, limitations and nuances

15 possible entity scenarios for the QBI deduction

5 must ask questions

Consider depreciation and other key elements going forward

Important Take Away Information if Working with the IRS

Know with whom you are working at the IRS –

[if working with a difficult person](#) – take appropriate actions

and [consider how to make concessions with the IRS](#)

Understand the roles of participants

Seek to understand interests

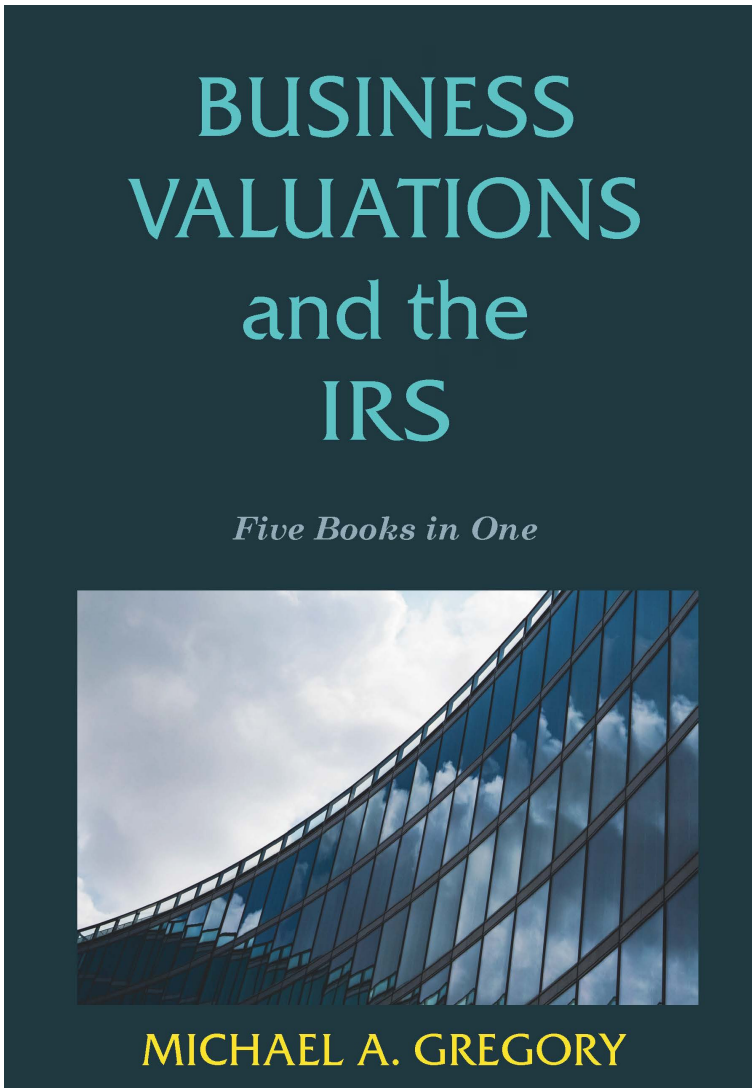
Do not be afraid to ask questions

Consider options

Ask for a valuer

Ask to elevate in management as a neutral party given ownership of the issue by the revenue agent or estate tax attorney

For complete, comprehensive, up-to-date discussion of everything discussed in this e-book, order your copy of [Business Valuations and the IRS: Five Books in One](#) today:



[To order or to find more information about this book](#)

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”

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

PART ONE: IRS STRUCTURE and PROCESS

Chapter 1 - IRS Culture – Then and Now

Chapter 2 – Understanding IRS Rules of Engagement and How to Use Them

Chapter 3 – Classification at the IRS

Chapter 4 – Working with Valuers and Specialists at the IRS

Chapter 5 – Expert Witnesses and the IRS

PART TWO: RESOLVING CONFLICT WITH THE IRS

Chapter 6 – The Most Common Errors in Appraisals and Ten Golden Rules

Chapter 7 – Issue Resolution and Mediation at the IRS

Chapter 8 – Using the IRS Evaluation Process to Resolve Issues

Chapter 9 – Resolving Conflicts with IRS Teams
and Agents with Key Take-Aways

Chapter 10 – Writing a Business Valuation Report
for the IRS while Avoiding Penalties

PART THREE: VALUING NON-CONTROLLING INTERESTS IN S-CORPS FOR THE IRS

Chapter 11 - Introduction to S-Corps and the IRS

Chapter 12 - IRS Non-Controlling Interests in
S-Corps Job Aid with Commentary

PART FOUR: VALUING REASONABLE COMPENSATION FOR THE IRS

Chapter 13 – Introduction to Reasonable Compensation

Chapter 14 – IRS Reasonable Compensation
Job Aid with Commentary

PART FIVE: DISCOUNT FOR LACK OF MARKETABILITY AND THE IRS

Chapter 15 – Introduction to DLOMs and the IRS

Chapter 16 - IRS DLOM Job Aid with Commentary

[To order or to find more information about this book](#)

BUSINESS VALUATIONS AND THE IRS by**Michael A. Gregory****A review by Michael D. Pakter, CPA, CFF, CGMA,
CFE, CVA, MAFF, CA, CIRA, CDBV**

Business Valuations and the IRS: Five Books in One is the most comprehensive publication ever written for business valuers who prepare appraisals for federal tax purposes. It compiles five books into one with five parts; the first two parts present processes and approaches to resolve conflict, followed by three parts addressing the most common adjustment areas by IRS engineers and valuers.

Part One offers an orientation to IRS organization and culture, IRS official and unofficial rules of engagement, how classification works in general and in business valuations, suggestions for how to work with IRS valuers and specialists, and recommendations for using expert witnesses.

Part Two shows the reader how to resolve issues with the IRS. The most common errors in valuation are presented, followed by strategies for issue resolution and mediation, suggestions for using the IRS evaluation process to resolve issues, strategies for resolving conflicts with IRS teams and agents, and suggestions for writing a business valuation report for the IRS while avoiding potential penalties.

Part Three focuses on S corp valuations and the additional risks associated with S corps. Fifteen items are presented that business valuers should request from clients in every S corp valuation. Recommendations are then offered based on how the IRS approaches S corp valuation issues.

Part Four addresses reasonable compensation. This includes a thorough review and critique of the IRS Job Aid on reasonable compensation as well as its extremely useful appendix. Specific recommendations are presented based on practical experiences with the IRS.

Part Five provides the reader with the most current thinking, ideas, tools, and approaches related to discount for lack of marketability. The IRS Job Aid is presented and critiqued with the most current thinking by then-current as well as new models used by valuers.

Additional details:

- 181 Practical pointers = 11.5 per chapter, placed at the end of each chapter. These are hands-on.
- 38 Examples (one to four-page real-life stories from Mr. Gregory's actual experiences working with valuation issues in all areas covered by the book)
- 25 Golden suggestions for avoiding/reducing/resolving conflict with the IRS
- 44 Helpful charts photos scattered throughout the book
- 233 Need-to-know IRS terms in a special IRS glossary
- 150 Acronyms for valuation professionals
- Audit Process Chart, Negotiation Process Chart, Negotiation Strategies Chart
- 3 full Job Aids covering the most common areas of valuation friction between taxpayers and the IRS written by original champions with up-to-date commentaries by that same champion plus inputs by many other valuation professionals who were specially solicited for comments for this edition by the author.

In short, this book is a "must-have" book for professionals...Mr. Gregory calls this book "the most comprehensive and up-to-date book on this subject ever written." There is no other book available (or even possible, given his background) which rises to this level of quality and thoroughness in the valuation world.

Michael D. Pakter, CPA, CFF, CGMA, CFE, CVA, MAFF, CA, CIRA, CDBV, NACVA Instructor, and Managing Member of Gould & Pakter Associates, LLC, a Chicago-based CPA, business valuation and litigation support services firm. Mr. Pakter has more than thirty-five years of experience in accounting, forensic accounting, financial analysis, financial forensics, business economics, fraud examinations and investigations, including more than fifteen years of experience in economic damages and business valuations. Courts and arbitral bodies have recognized him as an expert in accounting, financial analysis, financial forensics, economic damages, business valuations and business economics.

[To order or to find more information about this book](#)