

# What the IRS Looks for in a Business Valuation Report

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

## Background

During this webinar, I am tying together some of the most common mistakes found by IRS business valuers. Once again, I can't over-emphasize the value of acquiring my book [Business Valuations and the IRS: Five Books in One](#) in which I expand at length on all of the following. My book, available at significant discount from BVR (see the back pages of this e-book), will help you more than I can in my one-hour presentation to prepare a business valuation report for the IRS given how the IRS reviews business valuation reports.

During my career at the IRS I was a business valuer, testified in U.S. Tax Court and prepared for testimony in over a dozen cases, was the manager of a group of up to 21 experts and later headed up business valuation at the IRS for 11 years. During that time [IRS business valuation standards](#) were introduced into the Internal Revenue Manual. A number of initiatives were undertaken including forming and a core group of top business valuers to identify the most common errors in valuations under my direction.

To give employees the best chance to shine, business valuers at the IRS were asked to form teams to conduct research and prepare white papers to enhance education and consistency with IRS business valuers. It was my pleasure to lead IRS teams producing white papers on a host of topics. Since leaving the IRS I have critiqued three of the publicly released white papers: on the [discount for lack of marketability](#), [valuing non-controlling S-corps](#) and [reasonable compensation](#). These have been presented in earlier BVR webinars. The most recent commentary on these topics and others is included in my latest book, [Business Valuations and the IRS: Five Books in One](#).

I remain in contact with IRS employees — from the front line level to the executive level — associated with various IRS issues including business valuation. In addition, I continually work with business valuers, attorneys and others concerned with business valuation and the IRS to help them resolve their issues. Today my practice is oriented toward resolving conflict between parties using alternative dispute resolution techniques.

What follows is the outline of my presentation together with links I believe you will find helpful.

### **What the IRS Looks for in a Business Valuation Report**

Valuations and potential pitfalls

Understanding the IRS and issue resolution

Estate and gift tax classification

Writing a business valuation report - valuation issues

- Sub S valuations and tax affecting
- Reasonable compensation
- Common errors investigated at the IRS
- IRS review with an opinion of value  
take away key points

Understanding the IRS

Brief comments on IRS history 1913-2000

Eleven divisions – need to understand silos and culture since 2000

Compliance–four divisions–different cultures

Your primary interest as accountants

- [Large Business and International \(LB&I\)](#)
- [Small Business and Self Employed \(SBSE\)](#) –  
Where [Estate and Gift \(E&G\)](#) are located
- [Tax Exempt and Governmental Entities \(TEGE\)](#)
- [Appeals](#)
- [Counsel - IRS](#) and [DOJ Tax Litigation Division](#)

Large Business and International Division

Thirty-five technical campaigns

- Four regions (NE-New York, Eastern-Downer's Grove, IL, Central-Houston, Western- Oakland)
- Issues of your potential concern
- Pass-through entities
- Enterprise activities
- Cross-border activities
- Treaty and transfer pricing operations

[Link to campaigns](#)

Case Manager and Senior Revenue Agent

Specialists are consultants and do not control case, but may be issue specialists

- [Engineering IRM 4.48.4 \(Section 4. BV Guidelines\)](#)
- Computer Audit Specialists
- Financial products in FS
- Economists and International  
Examiners in "I" of "LB&I"

Counsel

Engineering program – valuers reside here in IRS

Internal consultants to all divisions  
 Three territory managers  
 30 managers  
 200 technical employees (approximately  
 110 credentialed valuers)  
 Small Business and Self Employed Division  
 Examination

- General Program: Team Manager  
 and Revenue Agent Control
- [Estate and Gift \(E&G\) IRM 4.4.425](#)
- Classification process joint E&G and valuers
- E&G manager and E&G attorney control

Collection Counsel

Tax Exempt and Governmental Entities Division  
 Team manager and revenue agent control  
 Business Valuator Issues

- ESOPs
- Related for-profit entities
- Gifts in kind
- Services provided
- Reasonable compensation initiatives

Appeals Division  
 Case closes out of examination unagreed and  
 goes to the internal IRS Appeals Division  
 Goal to settle cases due to hazards of litigation  
 Targets independent ex parte rules

IRS Counsel  
 IRS Office of Chief Counsel

- Operations
- Technical
- All non-litigation work (legislative,  
 regulation, interpretation)

- Corporate
- International
- Technical advice

IRS Division Counsel  
 IRS Special Trial Counsel  
 DOJ Tax Litigation Division for refund cases

IRS Job Aids  
[DLOM Job Aid for IRS Professionals September 25, 2009](#)  
[Reasonable Compensation Job Aid for IRS  
 Professionals October 29, 2014](#)  
[Reasonable Compensation Job Aid  
 Appendices October 29, 2014](#)  
[S-Corp Valuation Job Aid for IRS  
 Professionals October 29, 2014](#)

Subchapter S Valuations  
 Tax Affecting

- Methods
- [Fannon – Fannon/Sellers Paper](#)
- Grabowski
- Mercer
- Treharne
- Van Vleet
- Court cases
- IRS commentary
- Estate and Gift
- Business valuers

Personal observations –Treharne & Fannon/Sellers

Key points from the [Estate of Gallagher  
 Case TCM 2011-148](#)

Write a report for the court and judge  
 Read court cases by judge on topic  
 What did Judge Halpern have to say?  
 - Report is testimony: Have to work with what I have

- Should NOT have used WACC in this instance
- Not going public and do not meet assumptions for WACC
- Use equity approach
- Do not use CAPM or modified CAPM for the discount rate
- Same concerns as above
- Use build-up method
- [Gross still governs](#) – “We will NOT impose an unjustified fictitious corporate tax rate” – IRS is six for six in court
- Don’t assume judge understands valuation concepts
- Understand discovery rules and process and work with attorney
- Have a third party review your report
- Provide court with evidence: if it is not in evidence it does not exist
- Valuation textbook for example
- Your job is to EDUCATE THE COURT

### [IRS Internal Memorandum on S-Corp Valuations](#)

SBSE only asked for a calculation without tax affecting from the IRS Engineering Program for non-controlling S-corp valuations

Memorandum indicates the IRS business valuer needs to consider [Revenue Ruling 59-60](#) and the [IRS Job Aid on S-corp valuations](#)

Note that the [IRS Job Aid on DLOM’s](#) presents 33 factors to consider

Consider 15 items to ask for when valuing an S-corp

Consider seven reasons why an S-corp may be higher risk than a C-corp

Reasonable Compensation

Over-compensation privately held companies

- Compensation compared with firm performance (RMA, BizMiner, Integra, Fintel, Dun and Bradstreet)
  - Types and areas of compensation
  - Data sources (Watson Wyatt, ERI, RMA, BVR, RIA, Troy, Dun and Bradstreet, trade associations and others)
  - Independent analysis
  - Exempt organizations (GuideStar and ERI)
- Subchapter S under-compensation
- Avoid employment and other taxes
  - Growing initiative at IRS

Common errors

Math logic

Standards [NACVA](#), ASA, AICPA—know and follow

- [Check Sheet NACVA Old Standards](#)

- Quality control

Documentation – explain why – tell a story

Written to audience

- Client

- Lay person

- IRS exam

- New report for litigation tailored to audience

- US Tax Court – IRS attorneys (90% of Federal tax cases)

- Refund cases – U.S. District Court and U.S. Court of Claims – note judge, jury, depositions, and DOJ attorneys (10% of Federal tax cases)

Types of analysis by IRS business valuers

- Informal consultation – no report for taxpayer

- Formal consultation – no report for taxpayer

- Limited scope examination – review with an opinion of value – most common

- Full examination – full appraisal by an IRS employee or an outside fee appraiser

IRS review with an opinion of value  
 Start with the report and valuer  
 Certified valuator credential and  
 meet standards of society  
 Engagement letter and limiting  
 conditions overview of report  
 Clear and concise with logical, mathematically  
 correct tables and appendices  
 Discounts, discount rates, adjustments to  
 income statement and balance sheet

IRS review with an opinion of value  
 Broad error categories

- Definition of value — standards
- Communication – written for audience clear and concise
- General – valuation date, logical, control  
 or minority valuation, comprehensive,  
 reasonableness of variables, and reconciliation
- Income approach – adjustments, discount rate, cash flow
- Market approach – guideline companies vs.  
 transactional databases, adjustments  
 to the subject company
- Asset based approach – expertise
- Reconciliation of approaches and method
- Reconciliation of discounts and premiums

#### Golden Rules

- Avoid an audit in the first place
- Know the most commonly audited  
 technical issues and be prepared
- Don't make common errors
- Always be professional
- Collaborate and partner with the IRS
- Don't be afraid to ask questions
- Understand the official and  
 unofficial IRS organization

- Don't take things personally
- Discuss information requests before issuance
- Follow up with the IRS when information  
 is provided
- Obtain technical assistance for yourself  
 and suggest technical assistance  
 for the IRS representative
- Explain to the IRS representative what it will take  
 to comply with their request for information
- Don't make assumptions about the person  
 you are working with at the IRS
- Know who the decision maker is  
 and deal with that person
- Have an agenda and an expected  
 time frame at meetings
- Don't disagree with inflammatory  
 or derogatory remarks
- Be prepared for issue resolution discussions
- Request assistance from management when needed
- Don't be afraid to request mediation
- Take pre-summons letters seriously

#### Examples

E&G adjustment without development  
 Appeals ex parte discussions and development  
 Preparing a case for tax return versus preparing a  
 case of U.S. Tax Court or refund cases for U.S.  
 District Court or the U.S. Court of Federal Claims  
 Family limited partnership reviews

#### Observations

Know with whom to work at the IRS  
 Raise issues in management as appropriate issue  
 resolution – mediation – litigation devil is  
 in the details in BV report - evidence  
 Courts more analytically oriented

- Avoid common errors
- Use facts of case and data to drive decisions

Issue resolution key points

Know the person with whom you are working at the IRS - social media, network, relationships

Understand the role of participants

Seek to understand interests –listen and answer what was asked

Do not be afraid to ask questions consider options

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

### **Working with the IRS to Resolve Issues**

#### **Related to Reasonable Compensation**

Having worked for the IRS for 28 years, with the IRS in the private sector for over six 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, and move toward 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 directly into negotiations, neuroscience suggests developing a relationship first. Developing a relationship will take some research. Ask who you will be meeting with. Learn as much as you can about the participants from social

media and from other contacts. Come to the first call or first meeting asking if the other party would be willing to spend a few minutes to get to know each other a bit and to develop an element of trust. In my books [The Servant Manager](#), [Peaceful Resolutions](#) and [Business Valuations and the IRS](#), I offer detailed ideas with real-world examples on how to approach this process.

#### **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 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

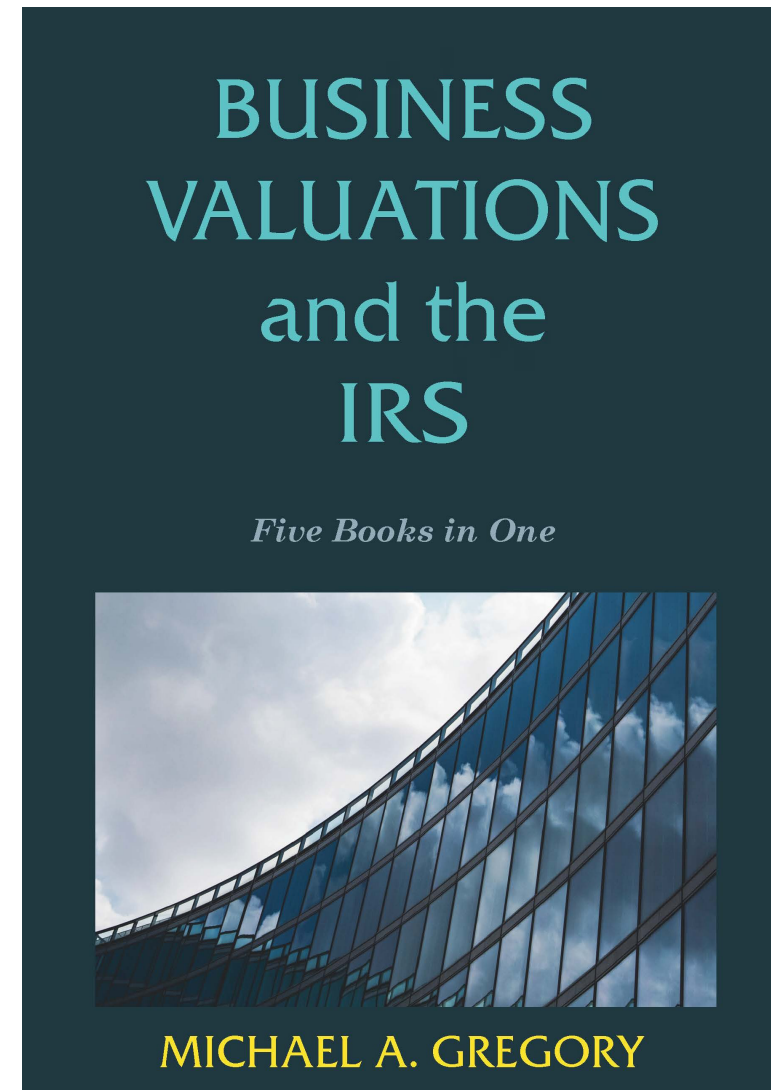
You are now ready to begin the process of a [negotiation](#). I offer a [weekly blog commentary](#) related to this topic with the IRS and others. Valuation is an inexact science. It is actually an art as well as a science. You need to be able to tell a story that makes sense to a third party. You need 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 in mind relative to your discussion of interests who you are trying to impact with respect to your valuation issue. It may take several iterations to ultimately reach the parties who are the decision makers.

The key in this process 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 the author, Mike Gregory, at 651-633-5331 and at [mg@mikegreg.com](mailto:mg@mikegreg.com). I would more than happy to assist you with your concerns.

As an added bonus, any potential client who purchases my latest book (see following pages for description) is entitled to a free 15-minute telephone conversation with me about any issue related to business valuation and the IRS. This 15-minute conversation I offer to all purchasers of the book at no additional charge or obligation.

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



[ORDER THIS BOOK for \\$249 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”*

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 from BVR](#)



## 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 from BVR](#)