

## Navigating the IRS and the IRS DLOM Job/Practice Aid

**James Hitchner, CPA/ABV/CFF, ASA**  
and  
**Michael Gregory, ASA, AVA, MBA**



## James Hitchner, CPA/ABV/CFF, ASA

- Managing Director, Financial Valuation Advisors
- CEO, Valuation Products and Services
- President, Financial Consulting Group
- Editor in Chief, *Financial Valuation and Litigation Expert*
- 32 years in valuation services
- Inductee in the AICPA BV Hall of Fame
- Coauthored over 20 courses; taught over 60 courses
- Published over 80 articles; made over 180 presentations
- Former member of the AICPA task force on BV standards
- Editor and/or coauthor of the books:
  - *Financial Valuation: Applications and Models*, 3rd edition
  - *Financial Valuation Workbook*, 3rd edition
  - *Valuation for Financial Reporting: Fair Value, Business Combinations, Intangible Assets, Goodwill, and Impairment Analysis*, 3rd edition
  - *PPC's Guide to Business Valuations*, 22nd edition



## Michael Gregory, ASA, AVA and MBA

- Michael Gregory Consulting LLC, focusing on ADR and risk management with the IRS
- *How to Work with the IRS: Strategies for Attorneys, Accountants, and Appraisers*
- <http://tinyurl.com/cs4ppyf>
- [mg@mikegreg.com](mailto:mg@mikegreg.com) [www.mikegreg.com](http://www.mikegreg.com)
- 651-633-5311
- Qualified Neutral with MN Supreme Court

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## Introduction

- How to engage the IRS organization
- Discount for Lack of Marketability – Job Aid for IRS Professionals and beyond
- How to work with the IRS

## IRS in General

- 95,000 employees
- In 2010 collected \$2.3 trillion
- Processed 230 million returns
- Spent \$.53 for each \$100 collected
- To see comprehensive statistics go to [www.irs.gov](http://www.irs.gov) and enter key words “IRS 2011 Data Book”

## The Four Examinations Divisions of the IRS

- Large Business and International (LB&I)
- Small Business and Self Employed (SBSE)
- Wage and Investment (W&I)
- Tax Exempt and Governmental Entities (TEGE)

## Large Business and International

- Six industries and one support function:  
CTM, FS, HMP, NRC, RFTH and GHW (10-1-2012)
- **Case Manager and Team Coordinator control case**
- **Specialists are consultants**
  - **Engineering IRM 4.4.48 [4.4.48.4 (BV Guidelines)] in NRC**
  - Employment tax to SBSE
  - Computer audit specialists in RFTH
  - Financial products in FS
  - Economists and international examiners in I of LB&I
- Counsel

## Engineering Program

- Why are BV's called engineers?
- Internal consultants to all divisions
- Four territory managers
- 32 managers
- 300 technical employees (approx. 180 credentialed valuers)

## Engineering Program Philosophy

- Improve voluntary compliance
  - Want to comply - Don't know how
  - Want to comply - Made a mistake
  - Want to comply - Disagreement on facts/law
  - Don't want to comply
- Enforce the tax laws
  - Fairness
  - Integrity
- Human component

## Small Business / Self Employed

- Examination
  - General program
    - **Team Manager and Revenue Agent control case, but ...**
    - No valuation specialists in SBSE exam
  - **Estate and Gift (E&G) IRM 4.4.425**
    - **E&G tax attorney and E&G manager control case**
    - **Classification process**
- Collection
- Counsel

## Classification of E&G Returns

- Filed in Cincinnati or Ogden, Utah
- Initial classification by valuator and estate and gift tax attorneys
- Process
- Sent to local estate and gift tax manager
- Process
- Protocol – E&G controls the case – Valuator needed to address valuation issues

## Appeals Division

- Case closes out of examination un-agreed 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)

## Litigation

- Write a new report for litigation
  - Write to your audience
  - Takes much greater effort
- U.S. tax court
  - 90% of federal tax issues end up here
  - IRS attorneys - no depositions - report is testimony
- Refund cases – U.S. district court or court of claims
  - DOJ tax lit division attorneys - depositions
  - Judge or jury trial in U.S. district court

## Working With the IRS as an Expert and Testifying in Tax Court

- Hitchner experiences
  - Retained as an expert by the IRS on two engagements
  - Testified in tax court twice
    - Retained by the IRS
    - Retained by the taxpayer
- Gregory experiences
  - Working with internal IRS and outside experts
  - Testified in tax court twice and deposed numerous times
  - Managed a litigation support team for 9 years

## Discounts for Lack of Marketability and The IRS DLOM Job Aid

## Discount for Lack of Marketability Job Aid for IRS Professionals

- Quick background on the Job Aid
- Valuation Products and Services webinar August 23, 2011
- Methods
  - Benchmark approaches
  - Securities-based approaches
  - Analytical approaches
  - Other approaches

## Before We Go Any Further Let's Look at Some Polls on How the Valuation Profession is Handling DLOMs

## VPS Webinar Polling on DLOMs - What is the Valuation Profession Doing?\*

1. How many hours do you typically spend in determining a DLOM?

	<u>5/13/08</u>	<u>8/23/11</u>
a) Less than 5 hours	<b>67%</b>	<b>62%</b>
b) 5 to 10 hours	<b>22%</b>	<b>29%</b>
c) 10 to 20 hours	<b>8%</b>	<b>8%</b>
d) Over 20 hours	<b>3%</b>	<b>2%</b>

\*Valuation Products and Services, LLC [www.valuationproducts.com](http://www.valuationproducts.com)

## VPS Webinar Polling on DLOMs - What is the Valuation Profession Doing?

1. Which of the following DLOM models or data do you use?

	<u>2/10/09</u>	<u>8/23/11</u>
a) Restricted stock benchmark data	<b>84%</b>	<b>85%</b>
b) FMV Opinions restricted stock data	<b>50%</b>	<b>52%</b>
c) IPO studies benchmark data	<b>63%</b>	<b>53%</b>
d) Valuation Advisors IPO data	<b>24%</b>	<b>21%</b>

## VPS Webinar Polling on DLOMs - What is the Valuation Profession Doing?

November 3, 2010

1. If you use restricted stock studies, have you read the original published studies?

a) Yes	<b>23%</b>
b) No	<b>21%</b>
c) Have read summaries of the studies published elsewhere	<b>56%</b>

## VPS Webinar Polling on DLOMs - What is the Valuation Profession Doing?

August 23, 2011

1. Which of the following do you rely upon for determining a DLOM?

- |                      |            |
|----------------------|------------|
| a) LEAPS             | <b>14%</b> |
| b) Chaffe            | <b>8%</b>  |
| c) Longstaff         | <b>9%</b>  |
| d) QMDM              | <b>25%</b> |
| e) None of the above | <b>61%</b> |

## VPS Webinar Polling on DLOMs - What is the Valuation Profession Doing?

1. Do you believe this IRS DLOM Job Aid may/will change how you support and report on DLOMs?

- |        | <u>8/23/11</u> | <u>9/15/11</u> |
|--------|----------------|----------------|
| a) Yes | <b>81%</b>     | <b>67%</b>     |
| b) No  | <b>19%</b>     | <b>33%</b>     |

1. Do you believe that the IRS DLOM Job Aid will make you spend more time in determining a DLOM?

- |        |            |
|--------|------------|
| a) Yes | <b>85%</b> |
| b) No  | <b>15%</b> |

## Benchmark Approaches

- Restricted stock studies
- Pre-IPO studies
- *Mandelbaum* factors

## Restricted Stock Studies and Databases

- The valuation communities and the courts have taken an increasingly critical view of simply beginning with a summary statistic from a group of studies and going from there, either by:
  - Accepting the statistic as is
  - Adjusting it without a believable explanation
- Attention has turned to getting behind the data and deriving an appropriate discount from the data

## Restricted Stocks - Strengths

- The stock is identical to its freely traded counterpart, except for the duration of the resale restriction, and pricing data is available showing differences - liquid and illiquid shares
- Considerable raw data was available for analysis and many different independent analysts worked the data and produced numerical results
- Historically, these types of studies were the ones most often accepted by the Tax Court
  - This tendency is being challenged in recent times

## Restricted Stocks - Weaknesses

- **Lack of Current Market Data**
  - Rely on historical market data
  - With some of the data in the studies reaching back to 1966, it may not reflect the dynamics of current market conditions
- **Change in Holding Period for Restricted Stocks**
  - Imperative that the expected holding period of the subject company stock be compared to the restricted stock study holding period
  - Effective April 1997, a one-year holding period
  - Effective February 2008, a six-month holding period

## Restricted Stocks - Weaknesses

- ***The studies imply an unusually high return on investment in small company restricted stock***
- ***Reliance on averages of restricted stock studies***
  - Using measures of central tendency without an examination of the underlying data leads to the opportunity for mischaracterization of the true restricted stock trading patterns. For example:
    - The Maher Study discount range was 3% - 76%
    - The Johnson Study range was from a 10% premium to a 60% discount

## Exhibit A—Review FMV Restricted Stock Model

This memorandum is a summary of the results of my [IRS Engineer] two-part assignment (2009):

- 1) To analyze FMV Opinions' (FMV) model for determining the DLOM on private equity
- 2) To determine whether it is possible to use FMV's 475-transaction database to develop a statistically valid regression-based model to determine this discount

## Exhibit A—Review FMV Restricted Stock Model

The bottom line of inquiry/conclusion is threefold:

1. FMV Opinions' model is flawed insofar as explanation of the DLOMs on the restricted stock transactions in their database
2. Valuators cannot confidently rely on FMV's model when determining DLOMs on restricted stocks, much less on interests in private equity
3. Neither FMV's model nor multivariate regression analysis can be applied to FMV's database to confidently determine the DLOM on private equity

## Pre-IPO Studies

### Strengths

- Empirical evidence, market data
- Broad time period coverage

### Weaknesses

- Strong argument that factors other than marketability alone led to the price increase
- Pre-IPO companies rapidly evolving
  - Significant changes (difference in pre & post company)
  - Many companies in early stage of development
- Pre-IPO companies affected by changes in economic conditions
- Data includes only firms with successfully completed IPO's

## Pre-IPO Studies

- Pre-IPO transactions
  - Tend to be underpriced (most IPOs involve high growth companies) to fully subscribe the offering
  - Almost always involve related-party transactions (employees and company, service providers and company, etc.) and do not reflect arms-length terms
- There are indications that the *Willamette Management Associates Studies* 1999 and 2000 data may be skewed due to the dot.com "bubble"
- Frequently viewed as inflating DLOM

## Securities-Based Approaches

- Long-Term Equity Anticipation Securities (LEAPS)
- Longstaff Study
- Chaffee Study
- (note Finnerty in Appendix and Update)
  - New Article in The Journal of Derivatives Summer 2012
  - Good Source for Mid Size and Large Companies

## Analytical Approaches

- Wruck Private Placement Study
- Hertz and Smith
- Bajaj, Denis, Ferris, and Sarin
- Ashok Abbott

## Bajaj, Denis, Ferris and Sarin

### Strengths

- The Bajaj study, like the H & S study, concentrated primarily (82%) on companies traded over-the-counter
- Although there is some debate among critics, the Bajaj sample of 88 companies seems to be better defined
  - The registration status of the component private placements more confidently determined with about 58% being unregistered
- The use of primarily smaller companies seems to be better suited to the measurement of the effects of LOM than companies traded on major exchanges
- Bajaj considered five different parameters that were seen to affect discounts, one of which was a variable based on registration status
- Allowed a direct measurement of what Bajaj considered to be the effects of LOM
- His isolated discount amount of 7.23% is supported by his model but seems to be too low to survive the application of a sanity check

## Bajaj, Denis, Ferris and Sarin

### Weaknesses

- Spotlighted by a number of its critics including Pratt, Hall, Mercer and Mitchell and Norwalk
- These weaknesses are concentrated in the areas of concern over
  - Sample choice
  - Remaining presence of some uncertainty in actual registration status
  - Relatively low coefficient of determination or  $R^2$  factor generated by the regression model
  - Choice of a measurement date of 10 days after the announcement
- Certain writers have pointed to data errors in the sample and the failure to consider other transactions occurring within the analysis period that are considered to be logical choices with required data available

## Bajaj, Denis, Ferris and Sarin

- What the 7.23% LOM discount by Bajaj really measures
  - Whether, even if it truly measures a pure marketability component of discount, it is the proper level of discount to be considered in a transactional analysis
- Bajaj himself has been somewhat inconsistent in application
  - Using 7.23% in certain cases and a larger discount that is said to include the effects of assessment and monitoring costs in other cases
- It does not explicitly consider the length of the required holding period for an unregistered placement as a factor in the analysis
- Not all unregistered placements are subject to the same holding period limitations
  - Accordingly, the analysis of registered versus unregistered placements should not be treated as a binary variable as Bajaj has proposed
- Finally, critics argue that simply because some private placement shares are registered does not automatically make them freely tradable such that no DLOM should apply to them

## Other Approaches

- Qualitative Marketability Discount Model (QMDM)
- FMV Opinions
- Non-marketable Investment Company Evaluation (NICE)

## QMDM (Christopher Mercer)

### Strengths

- As its name states, the QMDM provides a quantitative basis for reaching an opinion of the DLOM
- Instead of arbitrarily selecting “35%” after a vague discussion of valuation theory and restricted stock studies
  - The QMDM allows the appraiser to estimate specific factors (e.g., rate of appreciation, holding period, and required rate of return), to conclude a specific DLOM from the calculation matrix

## QMDM (Christopher Mercer)

### Weaknesses

- While it avoids arbitrary selection of a DLOM
  - Factors can be just as arbitrary and subjective
- The matrix increases the number of things the appraiser needs to have an “opinion” about
  - Potentially leaving the appraiser over-extended on their clairvoyance about a multitude of events expected to occur many years into the future
- Alternatively, if the appraiser simply relies upon management (i.e., the “client”) projections for parameter estimation
  - The appraiser’s opinion of the DLOM might lack credibility and independence

## Additional Approaches for Consideration Not in Job Aid

- Valuation Advisors Detailed Database
- Pluris
- Finnerty Approach – Asian Options Pricing

## Important Take-Away Information

- Read the Job Aid, understand limitations, use aspects for your reports
- Use aspects in your report
- Know who you're working with at the IRS
- Understand the role of participants
- Seek to understand interests
- Do not be afraid to ask questions
- Consider options – valuator and/or management

## How to Work with the IRS

- Document all of your work
- Provide a clear, easily understood, well-written report
- If audited, develop a good professional relationship with the IRS estate and gift tax attorney or agent as well as the IRS valuer
- If necessary, ask for appropriate parties to assist you with your case