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IRS Reviews of Business Valuations Post-COVID

The past government shutdowns, budget cutbacks—and now the pandemic—have impacted the IRS and how it selects and reviews tax returns that include valuations. During a recent webinar, a former IRS manager who dealt with valuations at the agency (and who was there during the last financial crisis) gave some advice on preparing valuations for estate and gift tax purposes in today's environment

Déjà vu? Unlike the 2008 economic downturn, the IRS now has much less staff doing valuation work—about half of what it had back then. Therefore, staffing is a concern that may impact the quality of the review process. The IRS can close out more cases faster with a less rigorous attention to quality, so there is a danger in that regard.

As the IRS did back in 2008, it will give more attention to certain elements of valuations. "They focused on the low-hanging fruit because that was the easiest to do," the former IRS manager says. The first and foremost red flag is a discount for lack of marketability (DLOM), especially if DLOMs are being increased without adequate explanation. Second on the IRS radar screen has been S corporations because this is related to the issue of tax affecting, although it is not as prominent anymore due to tax law changes and recent court cases. The third red flag is reasonable compensation. These three areas will continue to be targeted as the most likely areas of noncompliance the IRS will scrutinize while it has less resources to work with.

5th Circuit Upholds Tax Court's Characterization of Interest and Discount Rulings

***Estate of Streightoff v. Commissioner,* 2020 U.S. App. LEXIS 10070 (March 31, 2020); *Estate of Streightoff v. Commissioner,* T.C. Memo 2018-178 (Oct. 24, 2018)**

A valuation dispute in an estate tax case turned on how to characterize the transferred interest in the decedent's limited partnership. The estate claimed it was an assignee interest, whereas the Internal Revenue Service argued it

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was a limited partner interest. Based on the controlling partnership agreement, an assignee had fewer rights. Consequently, the estate's valuation experts argued a discount for lack of control was appropriate, while the IRS' expert said it was inappropriate. Both parties agreed on applying a marketability discount but disagreed over the rate. The Tax Court adopted the IRS' characterization and discounts. Recently, the 5th Circuit Court of Appeals affirmed the Tax Court's interest characterization and valuation rulings.

Background. On Oct. 1, 2008, the decedent formed a limited partnership (LP) that was funded by the decedent's assets which were marketable securities and other investments. The LP had a sole general partner (GP), which managed the partnership subject to limitations in the partnership agreement. The decedent's daughter managed the GP.

The decedent had an 88.99% limited partner interest in the partnership. The GP (management company) held a 1% ownership interest, and the decedent's children held the remainder of the LP interests.

A partnership agreement (PA) gave limited partners some control. For example, it said that limited partners owning 75% or more of the partnership interests held by all limited partners could remove the general partner. If the partnership ended because of the removal of the GP, 75% of the limited partners could rebuild the partnership and elect a successor general partner. Also, 75% of the limited partners could approve the admission of additional limited partners. Further, 90% of the partnership interests could terminate the LP by written agreement.

Some transfer restrictions applied. A limited partner needed written approval from the general partner to sell or assign his or her interest in the LP. An "unadmitted assignee" (one who was never admitted as a substituted LP) was entitled to allocations and distributions but had no right to information or data related to the affairs of the partnership or to inspect the partnership's books, or have the rights of a general partner or limited partner under the applicable state statute.

Under the partnership agreement, an assignee could become a substituted limited partner if the assignee met three conditions: (1) there was consent by the general partner; (2) the interest transferred was a permitted transfer (as defined by the PA); and (3) the transferee executed the documents necessary to confirm the transferee was bound by the PA. A substituted limited partner had the same rights as an original limited partner.

Further, on Oct. 1, 2008, the decedent set up a revocable living trust and transferred his 88.99% LP interest to the trust. He was the sole beneficiary of the revocable trust and had power to change or terminate it during his life. The daughter who managed the company that held the GP interest served as trustee for the revocable trust.

The transfer occurred via an "Assignment of Interest" agreement that designated the decedent the "assignor" and the trust the "assignee." Under this transfer agreement, the decedent transferred with the LP interest "all and singular the rights and appurtenances thereto in anywise belonging." By signing the agreement, the revocable trust agreed to be bound by the partnership agreement. The decedent's daughter signed the transfer agreement as holder of the decedent's power of attorney, trustee of the revocable trust, and representing the management company that was the general partner.

The decedent died in May 2011. In August 2012, the estate filed an estate tax return in which it said the transferred interest was an assignee interest. The net asset value was about $7.3 million. It discounted that value by 37.2% to report a value of about $4.6 million. In a supplemental statement, the estate claimed discounts for lack of marketability, lack of control, and lack of liquidity.

In January 2015, the IRS issued a notice of deficiency of about $492,000. The service valued the transferred interest in the LP at about $6 million.

Tax court proceedings. The valuation depended on the type of interest the decedent transferred: assignee interest or limited partner interest.

The Tax Court found the transferred interest was a limited partner interest. For one, even though the transfer agreement labeled the transfer as an "assignment," the agreement said the revocable trust was entitled to all rights flowing from ownership of the decedent's limited partner interest. The court noted that the phrase all "rights and appurtenances" belonging to the decedent meant the right to vote as a limited partner and exercise the powers of LP holders under the partnership agreement.

Further, the court noted that the transaction met the conditions specified in the partnership agreement for admitting the transferred interest as a substituted limited partner. In signing on behalf of the general partner, the daughter consented to the transferee's admission. The parties stipulated the transfer qualified as a permitted transfer. The trust agreed to be bound by the terms of the partnership agreement. The daughter signed the assignment agreement on behalf of the trust.

Moreover, the court noted that the partnership agreement's provision that the assignee did not have the right to vote as a limited partner had no practical significance regardless of whether the interest was a limited partner interest or assignee interest. The reason was that the limited partners never voted on anything after execution of the agreement. Further, during his life, the decedent could revoke the transfer to the revocable trust. Had he done so, he would have held all the rights of a limited partner, including the right to vote on business matters.

The Tax Court characterized the transferred interest as a limited partner interest.

Valuation issues: The next issue concerned the implications of that characterization for the fair market value determination of the transferred interest. Did discounts apply, and, if so, which ones, and at which rate?

DLOC. The IRS' expert proceeded from the assumption that the contested interest was a limited partner interest. The expert found that, under the partnership agreement, the decedent's 88.99% interest held considerable influence and control over the management of the LP. They noted the provision that limited partners with a 75% interest had the power to remove general partners. Further, the partnership terminated if the general partner was removed. The expert said a buyer of the decedent's interest would pay more for the degree of control flowing from that interest. The expert concluded it was inappropriate to apply a discount for lack of control (DLOC).

In contrast, the estate's experts prepared a valuation based on the assumption that the transferred interest was an assignee interest. The experts found a 13.4% discount for lack of control was appropriate.

The court quickly resolved the issue, noting, since it found this was a limited partner interest, the interest did not lack control and there was no case for use of a discount for lack of control.

DLOM. The IRS' expert agreed that it was appropriate to apply a discount for lack of marketability (DLOM) because there was no ready market for interests in privately held entities. The expert also noted that the LP's financial condition was strong, and the entity was capable of making distributions each year. Diversification and high liquidity of the assets made the contested interest very attractive to a hypothetical buyer. Further, the decedent's interest had a significant amount of control, which also favored lowering the discount rate. The IRS' expert proposed an 18% DLOM rate.

In contrast, the estate's experts relied on statements from the entity's representatives that there would be no distributions in excess of the partners' tax liability in the foreseeable future. This policy, the experts argued, favored a higher discount rate. They concluded that a 27.5% DLOM rate was appropriate.

The Tax Court said it agreed with all experts that it was appropriate to use a DLOM. Since the court had concluded the interest was a limited partner interest, the estate experts' rate, based on the assumption of an assignee interest, was too high, the court said. It adopted the 18% DLOM rate the IRS' expert proposed.

Appeals court proceedings. The estate appealed the Tax Court decision with the 5th Circuit Court of Appeals, challenging the characterization of the transferred interest (as well as the validity of the deficiency notice).

The 5th Circuit noted that, even though the transfer document labeled the transaction an assignment, "the unambiguous language of the Assignment purports to convey more than an assignment interest." The court pointed to the language "all and singular the rights and appurtenances thereto in anywise belonging." There was no limiting or restrictive language, the court said. Therefore, it was "difficult to reconcile the Estate's characterization of the Assignment given the document's language." Further, the daughter's signature represented that the LP recognized this permitted transfer conveyed "all and singular … [the LP's] rights and appurtenances" of the decedent. This encompassed the 88.99% limited partnership interest."

In affirming the Tax Court's classification of the contested interest as a limited partnership interest, the 5th Circuit said it also affirmed the Tax Court's estate valuation.

Court Says Transfer Was for Fixed Percentage Not Fixed Dollar Amount

***Nelson v. Commissioner, T.C.* Memo 2020-81 (June 10, 2020)**

Two issues dominated this gift tax case in which the donor transferred limited partner interests in a partnership called Longspar into a trust. The taxpayers, by way of the limited liability company, Warren Equipment Co. (WEC) held a stake in a successful family business that owned several operating subsidiaries. Longspar owned WEC stock. One issue concerned the nature of the taxpayers' transferred partnership interests based on the language in the transfer documents. The other issue related to the appropriateness of discounts in determining the fair market value of WEC and the partnership interests.

Dollar amount or percentage interests? As part of a succession plan, on December 31, 2008, two transfers of limited partnership interests were made to a trust. One transfer involved a gift. The language in the transfer instrument said they desired to make a gift "having a fair market value of $2.096 million as of December 31, 2008 …, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment."

In a second transaction a few days later, interests in the partnership were sold. The memorandum of sale noted the transfer of an interest "having a fair market value of $20.0 million as of January 2, 2009 …, as determined by a qualified appraiser within one hundred and eighty (180) days of the effective date of this Assignment."

The court first decided whether the transfer of the LP interests involved the specific dollar amounts stated in the transfer instruments—$2.096 million and $20.0 million —or whether the instruments indicated a transfer of percentages in the partnership (i.e., 6.14% and 58.65%).

The court said it would look to the transfer documents rather than subsequent events to decide the amount of property the taxpayer gifted. It noted the language of the transfer provisions required transfer of an interest having a specified fair market value as determined by an appraiser within a specified period of time. In other words, fair market value here was qualified by the clauses "qualified appraiser" and the fixed time period. Therefore, the court, agreeing with the IRS, concluded the transfer involved fixed percentages, not dollar amounts, of limited partner interests.

Valuing LP Interests. In valuing the LP interests, it was necessary to value WEC. There was a question as to whether discounts for lack of control (DLOC) were appropriate based on the methodology employed by the appraiser. The court was presented with a 20% DLOC the petitioners' expert proposed and no minority discount at all based on the IRS expert's proposition that all valuations were on a noncontrolling interest basis.

In that regard, the court found that the valuations of WEC subsidiaries produced values of interests with some elements of control. The court found a 15% DLOC was appropriate. The court also adopted the petitioners' 30% discount for lack of marketability (DLOM).

Using the fair market value of WEC common stock as the starting point for valuing the limited partner interest in Longspar, the court also applied a 28% DLOM and a 5% DLOC to the LP valuations.

Delaware Court of Chancery Adopts Company's DCF Model as Fair Value Indicator

In a statutory appraisal action prompted by the 2016 buyout of minority shareholders by the controller of a private company, the Delaware Court of Chancery in Kruse v. Synapse Wireless, Inc., 2020 Del. Ch. LEXIS 238 (July 14, 2020), recently found there was no meaningful market-based evidence of fair value and neither expert opinion, based on standard valuation methods, was "wholly reliable." Forced to decide, the court adopted one expert's discounted cash flow analysis.

'Monumentally different valuations': In 2012, McWane Inc. bought a controlling stake in Synapse Wireless (Synapse), an "internet of things" (IoT) company. IoT was seen as a growth industry, but Synapse never lived up to its promise. The company kept missing management's projections by a wide margin and became reliant on ongoing funding from McWane to keep operating. The 2012 merger agreements gave McWane a right to buy newly issued Synapse shares at a per-share price based on the 2012 merger, as well as a right, beginning in 2018, to require the remaining minority shareholders to sell their stock to McWane.

In late 2013, McWane sued Synapse, alleging breaches and misrepresentations. The litigation settled in late 2015, with McWane winning a reduction in price of its call option to $0.42899 per share, reduced from the $4.997 per share it paid in 2012. McWane also secured a right to exercise the call option immediately and did so in early 2016. At that time, it acquired ownership of 99.346% of Synapse by offering shareholders $0.42899 per share. The petitioner rejected the offer and asked the Delaware Court of Chancery for a fair value determination under the state's appraisal statute.

At trial, the parties offered expert testimony. Both experts used the same three valuation techniques (analyses of prior purchases of company stock, comparable transactions analyses, and discounted cash flow models). The experts even "materially agreed on several important inputs," the court observed. However, "as has become standard fare for appraisal litigation, the experts reached monumentally different valuations," the court said.

In a nutshell, the petitioner's expert arrived at a fair value of $4.1876 per share. The company's (respondent's) expert declined to provide a single valuation, but his summary values ranged from $0.06 per share to $0.11 per share.

The court rejected the market-based evidence, including McWane's acquisitions of Synapse stock preceding the 2016 merger. Neither the stock purchases following the 2012 merger nor the 2016 merger took place in a competitive market, the court said. As for the 2012 merger, the court said this transaction was "stale" and did not represent evidence of Synapse's value at the time of the 2016 merger. Synapse, in 2016, faced different prospects than it did in 2012, the court noted.

The court also rejected the experts' comparable transaction analyses, calling this approach "a dicey valuation method in the best of circumstances." The experts' DCF valuations also had "significant flaws," the court said. It found particularly troubling both experts' reliance on management projections, considering Synapse's consistent failure to meet forecasts.

Normally, the court said, a fact-finder might determine neither party met its burden of proof and neither was entitled to a verdict. However, the statute required the court to provide a fair value appraisal. Therefore, the court decided to rely on the company expert's DCF (with a slight adjustment), noting the expert "credibly made the best of less than perfect data to reach a proportionately reliable conclusion."

The fair value of the company on the 2016 merger date was $0.228 per share, the court concluded—a notable drop from the $0.42899-per-share price McWane had offered to the dissenting shareholder in the context of the squeeze-out merger.

No 'Long-Recognized Principle' Against Use of Market Price as Fair Value Indicator, High Court Says

***Fir Tree Value Master Fund v. Jarden Corp.* (Jarden III), 2020 Del. LEXIS 237 (July 9, 2020)**

Last summer, in a statutory appraisal action involving a public company, the Delaware Court of Chancery based fair value on the unaffected market price. The court's decision came after the state Supreme Court, in Aruba Networks, had vigorously rejected the use of the unaffected market price. Unsurprisingly, the petitioners appealed the Jarden ruling with the Delaware Supreme Court, which recently affirmed all of the Court of Chancery's findings. The high court agreed with the trial court that a defective sale process made the deal price an unreliable indicator of value, and the high court declined to critique the Court of Chancery's discounted cash-flow inputs, emphasizing the Court of Chancery after all did not rely on its DCF-generated result for fair value.

The petitioners unsuccessfully appealed the value findings with the Delaware Supreme Court. The Supreme Court explained that it would defer to the Court of Chancery's fair value determination as long as the decision had a "reasonable basis in the record and in accepted financial principles relevant to determining the value of corporations and their stock."

The Supreme Court said the Delaware Court of Chancery "recognized correctly, however, neither Aruba nor our other recent appraisal decisions ruled out using any recognized valuation methods to support fair value." None of the high court's recent key decisions—DFC Global, Dell, and Aruba—as a matter of law ruled out the use of any "recognized financial measurement of fair value," the Supreme Court said. In each case, the court must consider "all relevant factors" in its fair value determination and explain its fair value determination based on the record before it. The high court said the vice chancellor, in adjudicating the instant case, "got the 'takeaway' exactly right from our recent appraisal decisions."

The high court noted that, initially, the petitioners urged the Court of Chancery not to rely on the deal price, pointing to a flawed negotiation process. However, on appeal, their argument was that the deal price should set the floor for the fair value determination. They went on to argue that a better process would have produced a higher deal price; further, the company failed to prove synergies. All told, the deal price was "logically the minimum for any fair value determination." But the petitioners also continued to argue synergies only mattered when the deal price was reliable.

"[S]ynergies cause us to find the Court of Chancery did not err for failing to treat the deal price as a floor for fair value," the Supreme Court said.

10 Time-Tested Ways to Build a Defensible Divorce Valuation

Business valuations prepared for divorce purposes can be much more challenging than valuations can be for other purposes because the rules differ among jurisdictions. There are no clear valuation guidelines for divorce in most states. For example, there's no specific definition of value in state statutes governing divorce. Also, divorce courts exercise a great deal of discretion—even if there is an abundance of judicial precedent (which can be confusing and contradictory).

In a chapter from Business Valuation in Divorce Case Law Compendium, 4th edition, the author covers 10 universal tips for valuation experts who do divorce work—pieces of advice that apply no matter the jurisdiction.

1. **Realize that it is a litigation.** The very first thing to realize in doing a valuation for divorce is that it is a litigation. How many times have you heard of an amicable divorce? Virtually all are contentious, some more than others. Therefore, even though divorce cases may be a small percentage of the typical valuation practice, they account for the fact that a high percentage of the practice's valuation experts are called to testify as an expert witness. The valuation expert has to act accordingly, understanding that what you say and what you do are subject to challenge.
2. **Nail down the valuation date.** Very early in the process, get a clear answer to the issue of the valuation date. This is a fundamental aspect to understand upfront. It could be the trial date, the complaint date, or the date of the divorce or separation. Most often, you're dealing with an attorney (two attorneys if mutually agreed to or appointed by the court). Ask them to set the stage in terms of the valuation date—there could be multiple valuation dates as well.
3. **Know the relevant valuation standard.** Because the standard of value for divorce differs by jurisdiction, you need a complete understanding of the appropriate standard to use. It changes by state and sometimes within a state (and even within counties in states). However, while it is your responsibility to understand what the appropriate standards of value are, it's not your responsibility to choose the right one. That's something that you and the client should agree to.
4. **Read prior case law very carefully.** Rules for divorce valuations vary not only from state to state, but also by counties within some states. Therefore, you must read the prior case law very carefully. It's an area in which the case law is not well developed. In many states, there's no definitive case law and the courts use "fair market value" when they really mean something else because the judges just find "fair market value" to be a convenient phrase. Also, family law courts treat discounts and premiums differently than courts in conventional valuation cases, so you need to study relevant case law in this regard.

5. **Develop questions for both spouses.** In addition to questioning the attorneys early on, you need to ask questions of the titled spouse and/or the outside spouse (depending on which one is your client and what kind of access you have). If you are mutually agreed to or court-appointed, you can expect to speak with both parties.
6. **Get a list of entities involved.** Ask for a list of the entities and the types of ownership of the entities, the ownership by the parties to the divorce, a brief description of the overall situation, and the number of companies involved. For instance, does another entity own the real estate that is leased to the subject company? While you may not be directly involved in valuing that real estate entity, you would want to make sure that you are consistent in terms of the lease payments and other aspects of the intercompany relationships between the real estate owner and the subject company that you may be valuing.
7. **Memorialize key data.** Put it in writing! This is one of the differences between valuations for divorce and valuations for other purposes. When you send information requests to the attorneys, the litigants, and the business owners, ask for written responses (even if they say that what you want does not exist). Why bother with this? This is a litigation, so you need to cover yourself in case you are challenged in court.
8. **Be prepared to teach.** Because of the small amount of case law developed, divorce courts tend to be not as cognizant of business valuation theory and methodology as other courts. Divorce courts hear so many different issues that it limits the depth they consider when they have to deal with business valuations.
9. **Carefully manage your time and cases.** With a divorce valuation engagement, you're generally not in control of your own schedule. It's not unusual to get a call at the last minute about various deadlines or court appearances. This can be a big problem unless you manage your time and your cases appropriately.
10. **Watch your fees.** In divorce work, individuals, not company clients or law firms, are paying you. And these individuals are shelling out a lot of money in connection with the divorce, so it often places an absolute ceiling on what can be charged. Sometimes you are working for the outside spouse and money is a problem. Many valuation experts will not take a divorce case without a retainer and an arrangement to be paid monthly.

Conclusion

You'll encounter other issues in a divorce engagement, including buy-sell agreements, noncompete covenants, goodwill, and the double dip. Also, the lack of objectivity appears to be more prevalent in family law matters than in other types of cases. Therefore, the valuation expert must take extra care to avoid any pressure toward bias in favor of the client.

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