Mueller Prost PC
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VALUATION REPORT

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VALUATION ISSUES UPDATE

DLOMs: A New Normal?

Taxpayers and the IRS do not always see eye to eye about discounts for lack of marketability (DLOM). In 2008, the IRS formed a team that developed the *Discount for Lack of Marketability Job Aid for Valuation Professionals*, issued internally to the IRS in 2009 and made available to the public in 2011.

The Job Aid is meant to provide information to IRS valuation analysts when considering the DLOM. In developing this document, the IRS sought to clarify the definition of the DLOM, discuss the state of the art in estimating DLOMs, analyze the strengths and weaknesses of various models, review court commentaries, and document their concerns with 18 methods under the four approaches considered.

What's the Big Deal?

As the Job Aid acknowledges, a DLOM can result in a significant reduction of value in a business interest, and is the subject of much controversy in estate and gift tax cases. The Job Aid hints at the IRS's preference when it suggests that both the IRS and the taxpayer start with one basic question: "Under the prevailing facts and circumstances, and considering the nature of the interest to be valued, why is the DLOM not zero?"

The Job Aid includes many provocative discussions in an effort to flesh out the answer to that question, such as:

- How some appraisers only consider the willing buyer, but "common sense and the courts have emphasized that a willing seller must also be considered."
- The controversy surrounding DLOMs for a controlling interest.
- How courts are increasingly reluctant to accept DLOMs derived from restricted stock studies without detailed analysis of study data and how it relates to the valuation at hand.
- What the IRS considers to be significant flaws in the FMV Restricted Stock Study and why IRS analysts should be cautious about accepting analyses based on this approach.
- The potential limitations of theoretical, quantitative models such as using put options as proxies for DLOMs, and how qualitative factors should also be considered.

What Does It All Mean?

The Job Aid offers critical insight for taxpayers and their appraisers into how and what the IRS thinks about various methods and approaches for determining DLOMs. Perhaps even more important, it also underscores the fact that certain valuation practices won't fly with the IRS.

It is clear that the IRS and the tax court have increasing expectations regarding valuation professionals' DLOM analyses and conclusions. The document also suggests that discounts of 40 percent or more are hard to support and, from the IRS's perspective, it's possible that the "new normal" may be substantially lower.

Interested in learning more about DLOM and the new Job Aid? We would be happy to discuss this topic with you further.

ESTATE AND GIFT PLANNING

FLPs: What Is the IRS Looking for?

For many years, the IRS has challenged the tax benefits of family limited partnerships (FLPs). The IRS generally denounces FLPs for lacking valid business purposes, suggesting that they are created solely as a way to transfer assets to family members to reduce estate and gift taxes.

In fact, Internal Revenue Code Section 2036 - the regulation used by the IRS to bring the full fair market value of the partnership assets back into an estate by negating the transfer of assets into the FLP - is the most litigated issue in estate and gift tax today.

To make Section 2036 claims stick, the IRS often focuses on the formation and operation of FLPs. When the IRS wins these cases, it's typically because the government has been able to show that the FLP's books and records do not reflect a bona fide business purpose and that the transferor actually received a disproportionate benefit from the assets in the FLP, which is not allowed.

Expect Scrutiny

According to tax attorney John Porter in a recent issue of *Business Valuation Update*, the IRS is "essentially looking to see whether, in forming and operating the entity, the partners have dotted the proverbial i's and crossed the t's." Porter suggests that the IRS will look at formation facts and operational facts, including:

Who: Were partners other than the decedent involved in the formation of the FLP?

What: Did the partners make valid contributions of assets to the FLP? Were the FLP's assets comingled with personal assets of the decedent?

Why: What were the non-tax reasons for creating the FLP, and did the FLP operate in concert with those reasons?

How: Was the partnership truly operated as a separate entity, at arm's length from the decedent? Were distributions made according to the provisions of the partnership agreement?

In investigating the answers to these questions, if the IRS finds that the FLP was not formed for a legitimate purpose and has not been operating properly, it's likely that the partnership's assets will indeed be considered as part of the estate. The key to establishing the validity of an FLP is to play it safe and operate it according to the rules.

Discounts in Question

Of course, even if the FLP is considered to be legitimate, the IRS often questions valuation discounts for lack of marketability and lack of control (see page 1 for more on discounts for lack of marketability). While case law has established the validity of these discounts, the issue for the IRS is often the extent of the discounts.

In 2006, the IRS issued FLP Appeals Settlement Guidelines that include a range of discounts "permitted" by the IRS. Porter also put together a similar matrix based on case law, which shows a number of cases with a significant range of relatively high discounts in the 30 percent to 40 percent range. Porter's research demonstrates that the cases with the highest discounts were those in which the court found the estate expert's valuation testimony more compelling than that of the government expert.

The conclusion Porter draws is that the valuation report is the "most important piece of evidence in a transfer tax dispute."

Given the high stakes involved in these cases, it's imperative to work with an experienced valuation analyst. The analyst should understand the valuation issues involved in FLPs and produce a valuation report that clearly presents the "facts, data and reasoning" behind his or her valuation conclusions.

Our valuation team is familiar with the challenges of estate planning. Contact us for more information about how to properly set up and value FLPs.

WHAT'S IT WORTH?

Valuation Issues in Distressed Businesses

Due to the economic decline and stagnation of the last few years, many companies have struggled to stay afloat. This economic downturn is attributable to a number of causes, all resulting in declining cash flow and an inability of many businesses to meet debt payments.

But other factors might also be contributing to distress: for example, a large customer going out of business, a key employee finding a better position elsewhere, a sharp increase in expenses (think gas or oil), or an aging owner who is in ill health.

Evaluating Distressed Businesses

Whatever the cause, the number of distressed business valuations is on the rise. Here are several important things to consider when evaluating a distressed business.

The first thing to consider is the future viability of the entity. Many valuations assume that past performance is indicative of future cash flow. With distressed companies, this is obviously not the case.

A good appraiser will review the circumstances of the distressed business, including industry potential, management capabilities and the level of financial distress. These elements will help determine the appropriate method to value the business. Aswath Damodaran of NYU's Stern School of Business identifies four scenarios and methodologies to consider:

1. If the company is in decline but its position is reversible, the analyst would initially value the company under the income approach, "as is" with the same management team. The analyst would then value the company with a better management team in place. The discount rate would be applied based on the probability of reversing the decline and rebuilding the company under either scenario.

Damodaran asserts that a rebirth of this nature is most likely if the company has come back from decline before, if its industry is generally healthy, and if it is the type of business that might benefit from an economic turnaround.

2. If the company's problems are not easily addressed with a new management team, an orderly liquidation using the cost approach would reflect the expected proceeds from an orderly sale of assets. Liquidation value reflecting an orderly (not a forced) liquidation is the standard of value in this case.

3. If the company's decline is reversible but it's highly distressed, equity investors may be interested because of the possibility of a big return. In this case, Damodaran suggests using the income approach and discounting cash flow to reflect the distressed nature of the business, incorporating continued losses and expenses required to turn the company around.

4. If the company is headed for extinction, value will be extremely depressed because asset value will likely be low and a sale will attract a limited pool of buyers. Value using the cost approach will reflect the "bargain basement" and stressed nature of the sale.

Experience Is Crucial

Obviously, there are many nuances to these types of valuations. Therefore, it is crucial to engage a credentialed, experienced valuation analyst.

Our firm is familiar with the complexities of distressed business valuations. Call us to discuss your specific needs.

Preparing for a Business Valuation

Business valuations require a lot of communication. In addition to meetings and calls, a large number of documents must be gathered, including financial statements, operating and financial data, contracts and other agreements. Prepare for the process by taking a few steps to get ready:

Make the team aware. The valuation analyst will likely be interacting with the company's accounting, legal and finance teams, so let them know what to expect. They will probably be asked to gather a relatively long list of documents, and the analyst may have follow-up questions. Give your team permission to speak with the valuation analyst as needed.

Set aside time. The valuation analyst will certainly respect your time and priorities, but he or she will need to have detailed conversations with the company's owners and other employees. Be sure to provide access to relevant employees, and be available for these scheduled meetings. This type of cooperation and availability will make the valuation process smoother and more efficient.

Understand the purpose. Business owners often have a certain valuation figure in their minds. Don't be disappointed if the valuation doesn't match this number. Remember, the ultimate conclusion of value must reflect standards and practices dictated by the AICPA and other organizations. Valuation analysts must consider value using a number of different methodologies and provide a neutral, unbiased opinion.

Understand the timeline. The valuation analyst should explain the various phases of the engagement before the engagement begins. If not, ask for a timeline. Be aware that it will require a fair amount of time for the analyst to digest all of the information, perform calculations and write the valuation report.

Considering a valuation? We can help you with these and other preparation steps.

For more information, please contact **Adam Herman, CPA/ABV/CFF, CVA, ASA, CFE** at 314.862.2070 or aherman@muellerprost.com.