



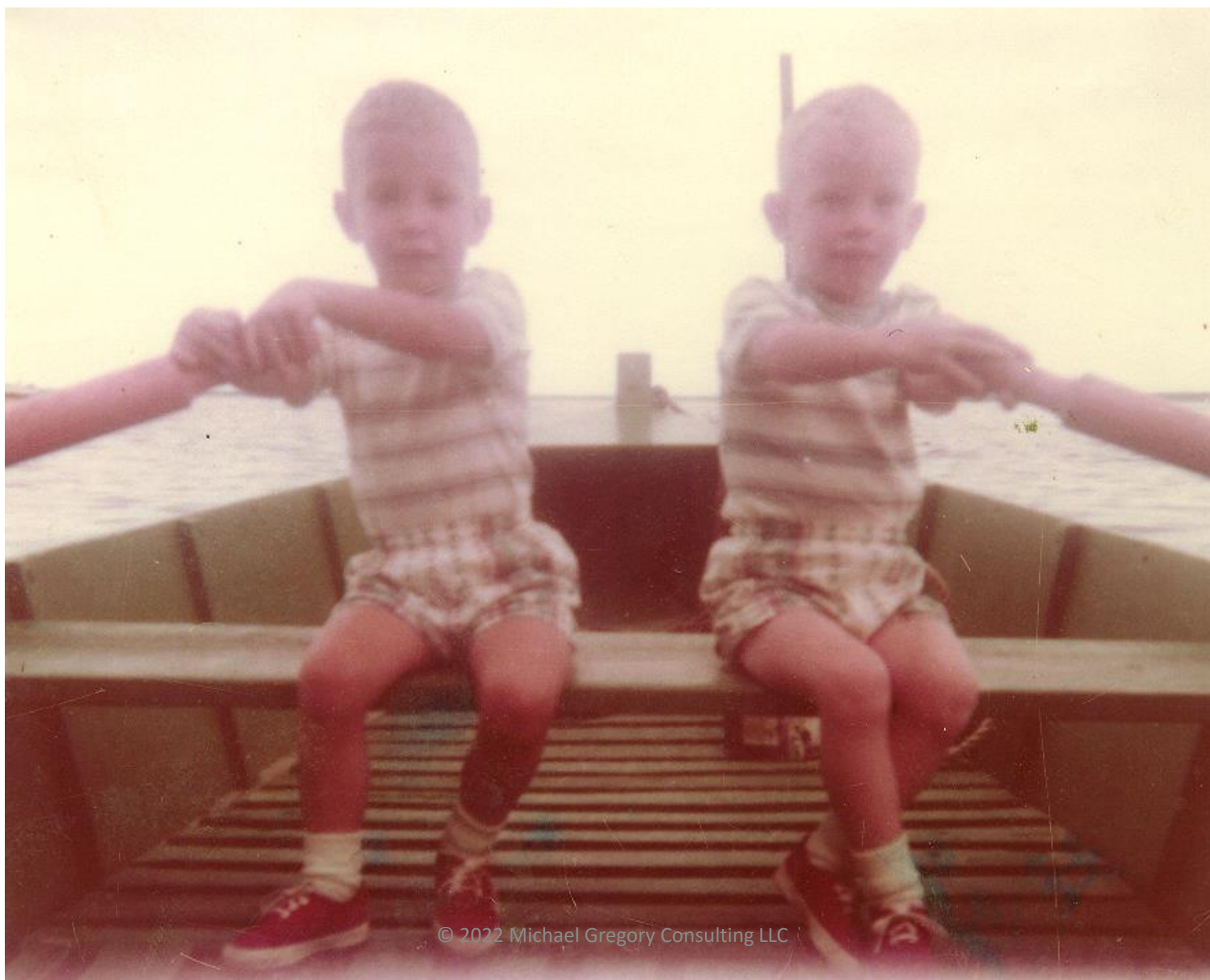
How to Avoid and What to do if Audited by the IRS



Presented by Michael Gregory

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Disclaimer



- The opinions presented here are those of Michael Gregory. **Any opinions presented in this seminar are those of the author** and do not represent an official position of his current or previous employers. **This material is offered for educational purposes only.** The author and his employer expressly disclaim any liability, including incidental or consequential damages, arising from the use of this material or any errors or omissions that may be contained in it.

Michael Gregory



- **Founder of Michael Gregory Consulting a firm focused on collaboration, conflict resolution, and speaking**
- **ASA and CVA**
- **28 years at the IRS**
- **Headed up business valuation at the IRS for 11 years**
- **Qualified Mediator with the MN Supreme Court 17 years**
- **Testified in U.S. Tax Court – ran litigation team with 21 experts 7 years**
- **Over 2,500 mediations, negotiations, facilitations**
- **12 books and over 35 articles**
- **Chair of Ethics and Oversight Board of NACVA**

As a Result of Today's Presentation You Will Be Able to:



- **Address pertinent changes at the IRS**
- **Describe how the IRS works and how to work with this IRS**
- **Communicate how classification works at the IRS on estate and gift tax audits, and how to avoid an audit**
- **Identify how to work with IRS personnel if audited**
- **Apply The Collaboration Effect and three bonus items**

BUSINESS VALUATIONS and the IRS

Five Books in One



MICHAEL A. GREGORY

Business Valuations and the IRS: Five Books in One

852 Pages with 38 Examples and over 180 Practical Pointers

- 1. Part One: IRS Structure and Process**
- 2. Part Two: Resolving Conflict with the IRS**
- 3. Part Three: Valuing Non-Controlling Interests in S-Corps**
- 4. Part Four: Valuing Reasonable Compensation and the IRS**
- 5. Part Five: Discount For Lack of Marketability and the IRS**

The IRS Big Picture



Introduction

- 1. What the IRS is intending to do in 2022**
- 2. What are the implications?**
- 3. What should you do?**

What the IRS Intends to Do



- **Quality Audit**
- **Quantity of Returns**
- **Taxpayer Bill of Rights
IRS Publication 1**

The IRS Today

- **The IRS was behind 21 million pieces of mail – today ?**
- **2.4 million paper returns from 2019**
- **1.7 million returns were in the error resolution unit**
- **2.5 million cases are in its account's management unit**
- **1.6 million returns are flagged for fraud**

- **Recent IRS hires of Engineers and Business Valuers**

Where to File Estate and Gift Tax Returns

- Form 706 and 709
- *Effective January 1, 2019*
- Department of the Treasury
Internal Revenue Service Center
Kansas City, MO 64999
- If submitting Form 706 or 709 by private delivery service, mail to:
- Internal Revenue Service
333 W. Pershing Rd
Kansas City, MO 64108

Classification of Estate and Gift Tax Returns



- **National Classification Process** – Kansas City now versus Cincinnati
- **Local Classification Process**

IRS Most Significant Issues Adjusted on Business Valuation Cases in 2021



- **Discounts**
- **Reasonable Compensation**
- **S-Corps**
- **Common Errors**

Historical Perspective of E&G Filings and Audits

Category	Year	Year	Year	Year
	Totals	% Audited	Totals	% Audited
	2017	2018	2018	2019
< \$ 5 Mil	23,013	2.5%	19,025	2.0%
\$5M<x<\$10M	8,095	13.4%	8,837	9.2%
>\$10 Mil	3,934	31.0%	4,975	21.7%
Estate Totals	35,042	8.2%	32,847	6.9%
Gift Totals	244,974	0.8%	244,770	0.8%

Category	Year	Year	Year	Year	Year	Year	Year	Year
	%	%	%				Avg Add	
	Audited	Audited	Audited	Totals	Total	Totals	Tax	Avg Refund
	2018	2019	2020	2018	2019	2020	2020	2020
<\$5 Mil	2.5%	2.0%		19,025			\$ 130,297	\$ 291,200
\$5M = x < \$10 M	13.4%	9.2%		8,837			\$ 90,018	\$ 124,724
>=\$ 10 Mil	31.0%	21.7%		4,975			\$ 407,983	\$ 502,295
Estate Totals	8.2%	6.9%	10.0%	32,847	25,742	15,023	\$ 263,800	\$ 366,505
Gift Totals	0.8%	0.8%	0.8%	244,770	239,618	158,095	\$ 216,127	\$ 468,262

Some Other Interesting Facts from IRS Data

- **For Estate Audits 18% are No Changes**
- **For Estate Audits 20% are Refunds**
- **Additional Tax Adjustments for Estates Amount to on Average**
 - \$126,000 for under \$5 million estates
 - \$ 88,000 for \$5 million up to \$10 million estates
 - \$335,000 for over \$10 million estates
- **For Gift Audits 43% are No Changes**
- **About 5% of Gift Cases Have Valuations. If 50% of Change Cases Are Valuations this Amounts to Approximately 5% Chance of Being Audited**

Estate and Gift Tax Ramifications

- **Goal to close cases in 6 months**
- **Goal to close out so many cases in FY 2022**
 - October 1, 2021 to September 30, 2022
 - It takes a month to close a case
 - Complete closed cases by no later than August 31 for year end
 - This means an agreed case with the closing letter
 - This means an unagreed case closed out of the group with the 30-day letter response to Appeals
 - If a case has less than 9 months on the statute when it arrives at Appeals, it will not be accepted – docket for court
- **Quantity goal**
- **Quality goal - TCJA**

Given IRS Budget

Quality will suffer

Taxpayer Bill of Rights IRS Publication Number 1

LB&I IRM 4.46.4.6 (12-13-2018) Information Document Request Process with Exhibit 4.46.4-1

Quantity – will not meet targets, but will try valiantly to meet targets

Outside of Business Valuation Observations

What Should You Do Relative to Valuations?

- **Have a qualified appraisal by a qualified appraiser and attach it to the return**
- **Understand how the IRS looks at them and plan accordingly**
- **Consider behavioral elements on audit**
- **Don't be afraid to go to Appeals**

Pertinent Federal Court Cases on Business Valuation



- Add Nelson case and newer cases
- Estate of **Michael Jackson** May 3, 2021 (Corp) Win for TP
- Estate of **Warne** February 18, 2021 Win for TP
- **Lucero v. U.S.** October 27, 2020 Win for TP
- Pierson M. **Greive v. Comm** March 2, 2020 Win for TP
- **Estate of Aaron U. Jones** August 19, 2019 (Corp) Win for TP (1120S)
- **Kress v. Comm** March 26, 2019 (Corp) Win for TP (1120S)
- Estate of **Gallagher** June 28, 2011
- **Guistina** TC Memo 2011-141 (Limited Partnership)
- **Dallas** T.C. Memo 2006-212 (Corp)
- **Adams** T.C. Memo 2002-80 (Corp)
- **Heck** T.C. Memo 2002-34 (Corp)
- **Wall** TC Memo 2001-75 (Corp)
- **Gross v. Commissioner** T.C. Memo 1999-254, aff'd 272 F. 3d 333 (6th Cir. 2001) cert denied, 537 U.S. 827 (2002) (Corp)

Michael J. Jackson

Asset	Estate	Commissioner	Tax Court	Percentage for the Winner
Jackson's Image and Likeness	\$3,078,000	\$161,307,045	\$4,153,912	99% TP
New Horizon Trust II 50% Interest in Sony/ATV	\$0	\$206,295,934	\$0	100% TP
New Horizon Trust III Mijac Music	\$2,267,316	\$114,263,615	\$107,313,561	94% IRS
Total	\$5,345,316	\$336,866,594	\$111,467,473	68% TP

Estate of Michael Jackson v. Commissioner,

- **Judge Holmes**

- And we find, as we have done consistently in the past apart from Estate of Jones, that by a preponderance of the evidence tax affecting is not appropriate here because the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets.

- We do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation [*83] of what that effect would be. In Estate of Jones, there was expert evidence on only one side of the question, and that made a difference.

But First 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

What Did Judge Halpern Have To Say Continued

- Gross Still Governs – **“We Will NOT Impose** an Unjustified Fictitious Corporate Tax Rate” – IRS is 6 for 6 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 Text Book for Example
- Your job is to **EDUCATE THE COURT**

Estate of Warne v. Commissioner,

T.C. Memo 2021-17 (Feb. 18, 2021)

- LLC operating agreement gave significant power to the majority interest holder; family trust had majority interest in every LLC
- Court values not was contributed, but what charity received
- **Here is a detailed analysis for DLOC for a majority interest**
- Using data and thoroughly supporting in a report will win
- **TP 5% to 8% Mergerstat Control Premium Study – considered factors specific LLC**
- **IRS 2%** closed in funds dissimilar to subject – took bottom of range - court rejected
- **Court 4%**
- **Court stated previously no DLOC for majority interest, in this case slight discount based on DLOC's by both parties**

Lucero v. United States,

**U.S. District Court for the District of New Mexico,
October 27, 2020, Civ. No. 17-1065 JCH/JFR**

- **TP claimed refund from \$2.38/sh to \$0.57/sh**
- **Prior court settlement – compulsion at play in court case -\$2.38/sh**
- **Valuation date August 2014 – negative cash flow from beginning 2011 accumulated \$608 million**
- **Four valuations January to July 2014 \$3.53/sh to \$4.10/sh; Sept 2015 redeemed for \$.48/sh**
- **TP expert appraisal negative cash flows, used Altman Z-score bankruptcy probability, DLOM 18%, DLOC 25%**
- **IRS review with opinion of value from exam and court case, agreed with discounts**
- **Court 100% for TP**

Lucero v. United States,

**U.S. District Court for the District of New Mexico,
October 27, 2020, Civ. No. 17-1065 JCH/JFR**

- **Expert testimony by TP with full appraisal**
- **IRS supplied a review with an opinion of value – totally discredited by the court**
- **IRS used a court case determination from litigation where one part was under duress - totally discredited by the court**
- **Implications at the IRS**

Pierson M. Grieve,

T.C. Memo. 2020-28 (March 2, 2020)

- **FMV of gift of 99.8% nonvoting interest in a GRAT Trust and Irrevocable Trust**
- **FMV by TP Expert**
 - **Used market and income approaches**
 - **Used closed end funds for DLOC**
 - **Used restricted stock studies for DL0M**
- **FMV by IRS Expert – A willing seller would attempt to take control – concluded a premium to buy out and take control of the controlling interest**
- **Court – no facts to support IRS theory – facts run contrary to IRS theory – not reasonably probable – no evidence of peer review methodology**

Pierson M. Grieve,

T.C. Memo. 2020-28 (March 2, 2020)

- **Cash, cash equivalents, and marketable securities**
- **Discounts total 35% at issue**
- **Court firmly rejected Government's assertion that 99.8% would buy 0.2% controlling interests – hypothetical with no basis in facts.**
- **Valuations very similar - went with original valuation by TP and did not criticize the NICE method; government witness took issue with holding period, but not approach**
- **No issues raised on the valuations of the entities, so the court did not have to address tax affecting by the TP's expert**

Estate of Aaron U. Jones,

T.C. Memo 2019-101

- Seneca Saw Mill (SSM)
- Seneca Jones Timber Company, LP
- Gifts of stock May 28, 2009
- Mr. Jones died September 14, 2014
- Valuing both entities for gift and estate
- Findings SSM – **Government no appraisal** argued law, **TP won with tax affecting**
- Findings SJTC – Operating vs. Holding Co., TP tax affected and 22% premium; Government did not tax affect – **“Mr. Reilly may not be exact, but it is more complete and more convincing than respondent’s 0% tax rate”**.

Estate of Aaron U. Jones

T.C. Memo 2019-101 (Aug. 19, 2019)

- **Valuation of SSC lumber mill and STJC timberlands May 28, 2009**
- **IRS SSC no valuation, STJC argued law not facts – tax affecting accepted**
- **TP Experts \$21 M and IRS \$141 M operating vs. holding company**

Category	Columbia (original)	Willamette	IRS	Court
SSC A voting	\$325	\$390	\$1,395	\$390
SSC B nonvoting 1	\$315	\$380	\$1,325	\$380
SSC B nonvoting 2	\$315	\$380	\$1,325	\$380
SJTC limited partnership	\$350	\$380	\$2,511	\$380
Rifle Range			\$4.20 (1%)	\$4.20

Kress v. United States,

March 26, 2019

- **U.S. District Court Case litigated by the Department of Justice Tax Litigation Division**
- **Both parties' tax affected cash flows minority owned shares**
- **Government's expert applied an S corp premium to account for perceived tax advantages – court declared itself neutral on this issue**
- **Note: not a U.S. Tax Court or U.S. Court of Appeals decision**
- **Note: Court did not address the issue of tax affecting in the opinion**
- **Note: The government gave recognition to tax affecting**

What is Mediation and a Mediator

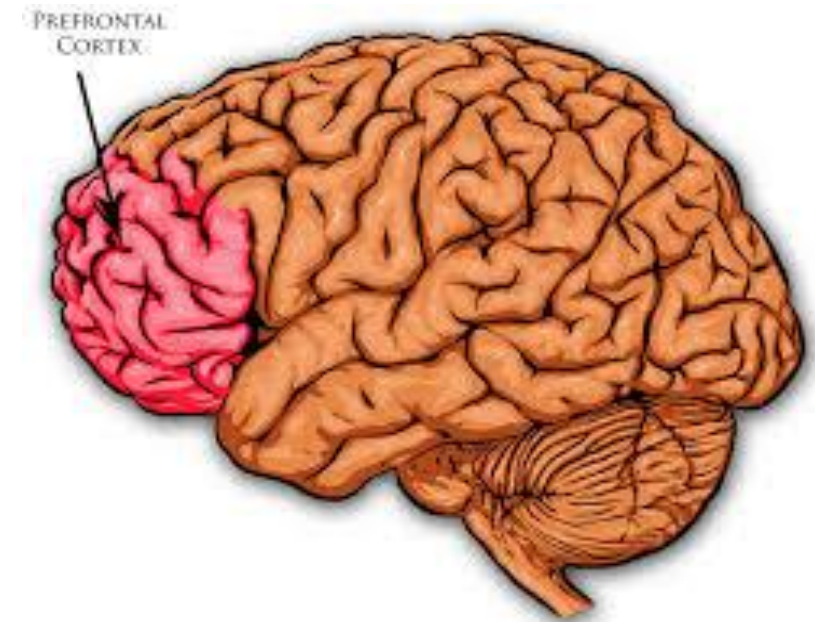
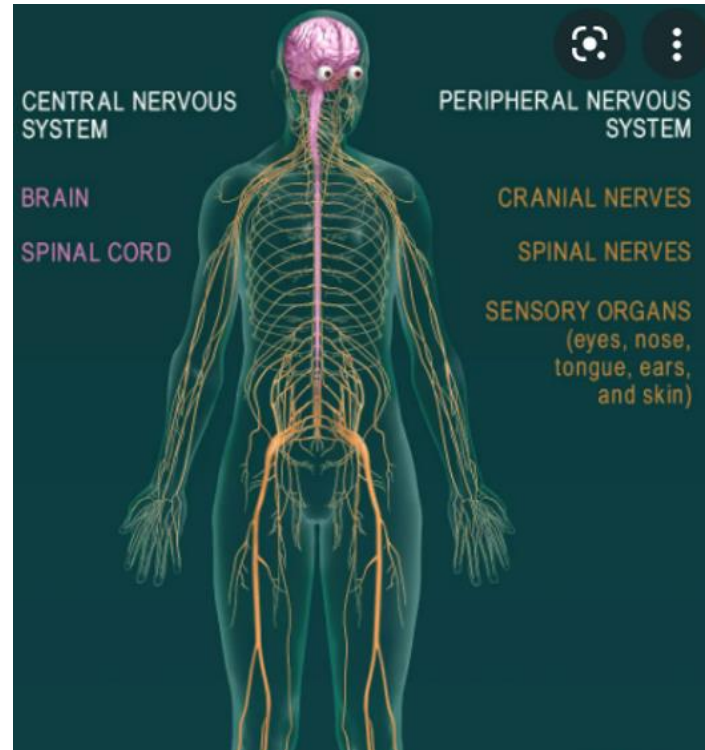
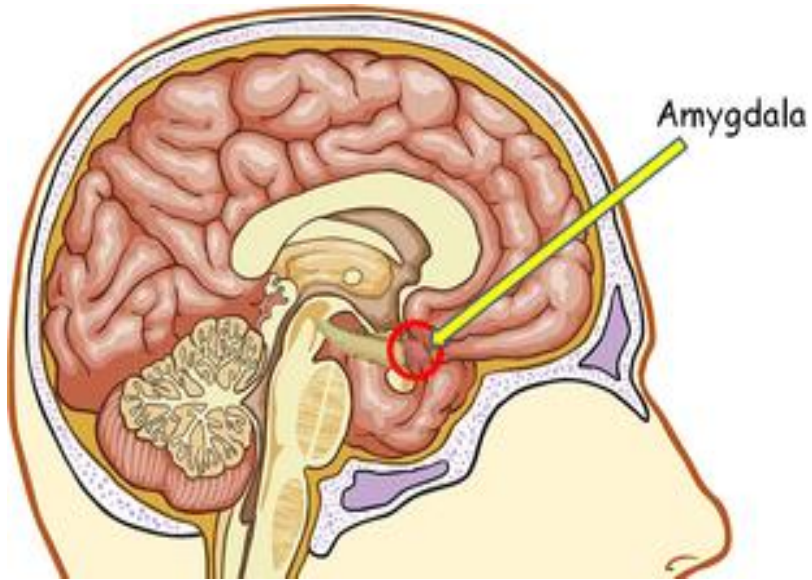
- **Mediation**
 - **Evaluative**
 - **Facilitative**
 - **Transformative**
- **Mediator**
 - **Qualified Mediator**
 - **True Neutral**

Thanks, Neuroscience!



- **Ericka Garms**, PhD U of MN and Her Team, Neuroscientist
- **John B. Molidor**, PhD Assoc. Dean MSU Medical School
- **Rick Hanson**, PhD Psychologist, Greater Good U of CA Berkeley
- **Terry Wu**, PhD Vanderbilt, Neuroscientist

Amygdala & Prefrontal Cortex



信 頼

Trust

trust



Choices

- **Confrontation**
- **Collaboration**



Escalation



Center Ourselves First



- **Calm the fire**
- Realize you need to **be there to help** if you are to overcome conflict with collaboration

The Prayer of St. Francis of Assisi – Religious Tradition

Lord, make me an instrument of your peace.

Where there is hatred, let me sow love;

Where there is injury, pardon;

Where there is darkness, light;

Grant that I may not so much seek

To be consoled as to console;

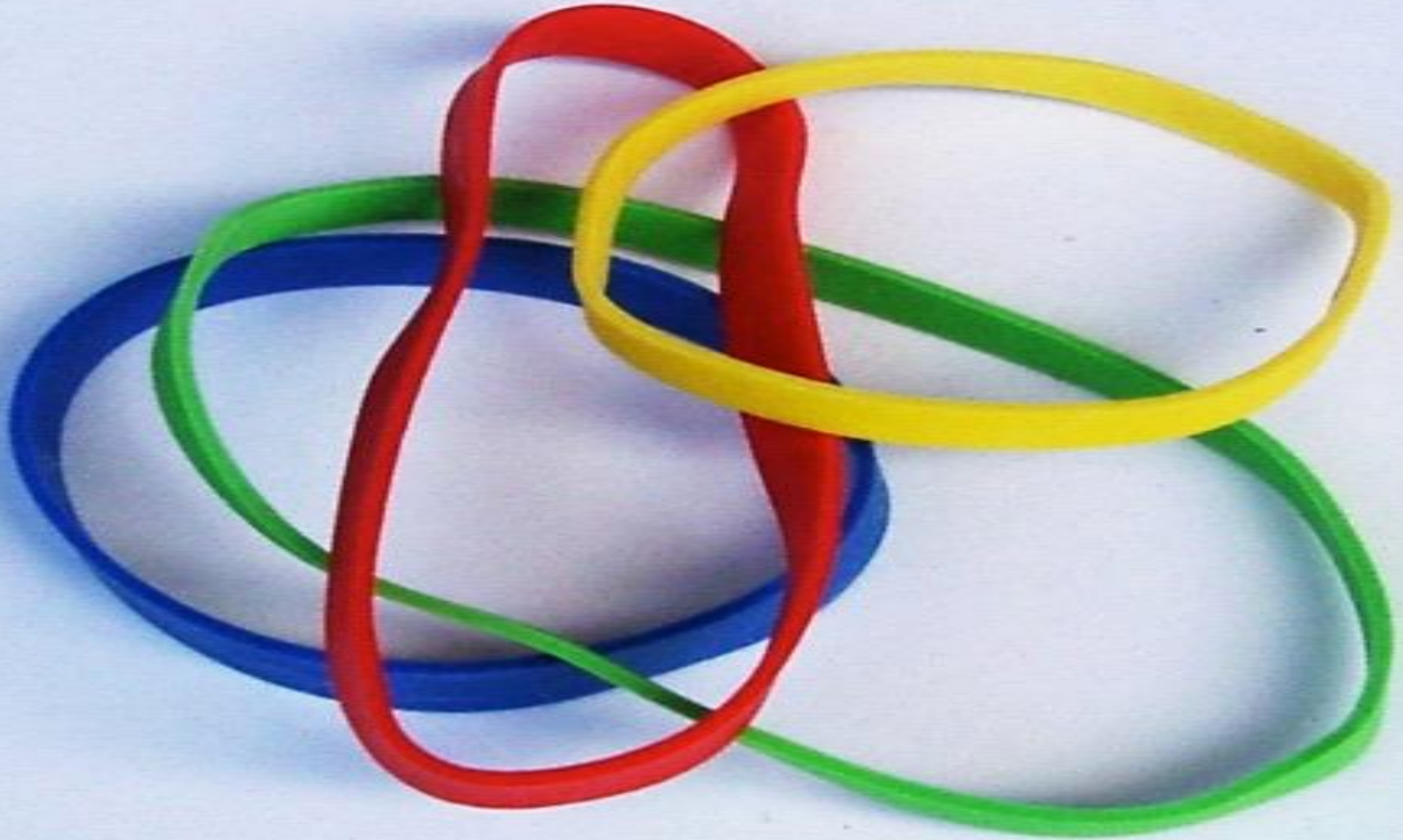
To be understood as to understand;

To be loved as to love.

**For it is in giving that we receive; it is in
pardonning that we are born to eternal life.**



Neuroplasticity – Ability to Change



Emotions Priorities Impacts





Communication



Conversational Intelligence

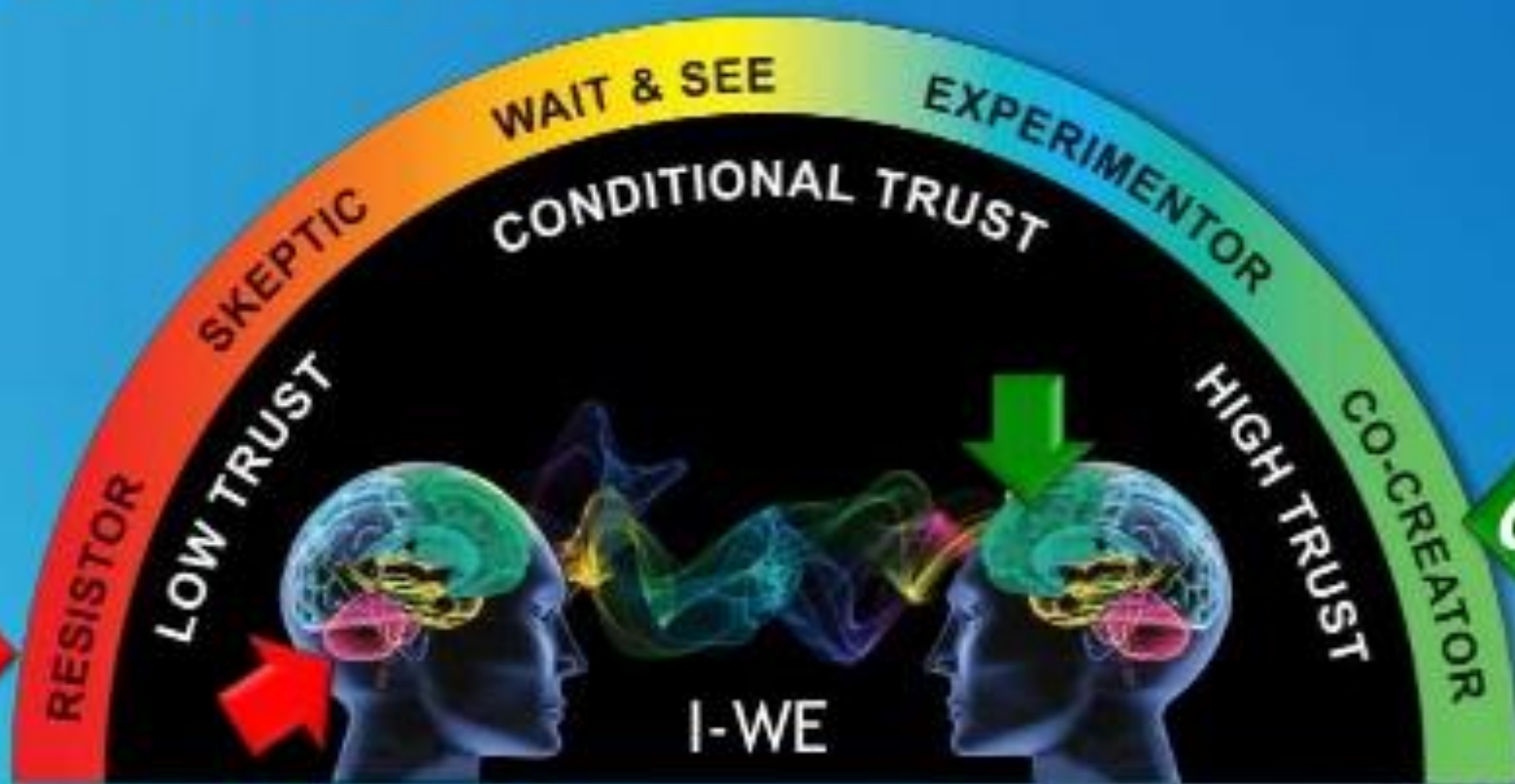
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Making the Invisible Visible!

PROTECT

Fight
Flight
Freeze
Appease
Distrust

Cortisol



Territorial Instincts

Vital Instincts

PARTNER

Wisdom
Innovation
Strategy
Empathy

Oxytocin

Foresight
Insight
Trust

Listen to Connect

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Listening Actively



Active Listening



- Paraphrase
- Ask open ended questions
- Ssuspend judgment
- Summarize
- Empathize
- Do NOT offer advice

Ways to Support Others

Lead with Compassion

Listen with Empathy

Compassion
Prefrontal Cortex

Calm
Confident
Competent

Empathy
Cerebral Cortex

Understand Their Feelings
Feel their Pain
Take Actions to Address
Pain



Negotiation

Official Alternative Dispute Resolution and the IRS

		Stages of IRS Process		
	Pre-Filing	Examination	Collection	Appeals
Type of Taxpayer				
LB&I	Compliance Assurance Program	Fast Track Settlement Early Referral to Appeals		Post Appeals Mediation
SBSE		Same as LB&I	Fast Track Mediation	Post Appeals Mediation
TEGE		Early Referral to Appeals		

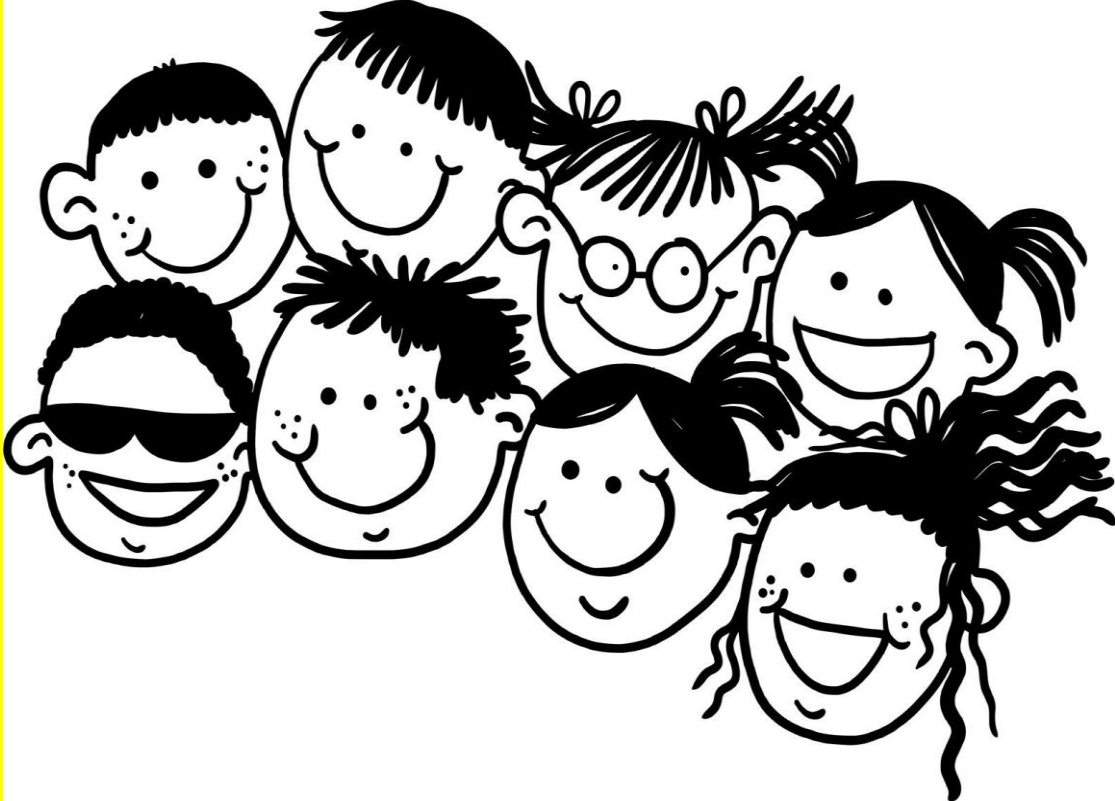
Three Part Process to Get What You Want



- You have to **decide what you want**
- You have to **ask for it**
- You have to **give three reasons why this is beneficial for them**

- **THEN be quiet AND LISTEN**

Yale University's Most Popular Class – Happiness - Neuroscience



- Gratitude 5 minutes a day
- Label negative feelings
- Make that decision good enough
- Appropriate touch with others
- Meditation 10 minutes daily

Reduce the Stress Response



- Maintain a sense of **control**
- Have a sense of **predictability** (routine and rituals)
- Have a sense of **progress** (make big projects into smaller elements and provide affirming feedback)

Connecting Relationships

Listening Actively

Educating Judiciously

Leads to Building Bridges and Negotiating Closure

Helpful Questions for Collaboration

Connecting Relationships

- What have you been thinking about?
- What is your story?
- What was the highlight of your week?
- Tell me about yourself/your business
- What are you working on lately?
- What is your passion?

Listening Actively

- What would you like to have happen?
- What worries/concerns do you have?
- What would it take for you to feel satisfied?
- What have we not covered that you would like me to know?
- What can I do to help you?
- Are there any other concerns or problems?

People versus Problems

- Be tough on the problem and gentle on the people
- Acknowledge your emotions and theirs without blame
- Treat others as they would like to be treated

Positions versus Interests

- Positions polarize – interests integrate
- Behind every entrenched position is at least one interest
- Interests hold the seeds to a solution

Resources for Collaboration

- *Peaceful Resolutions: A 60-Step Illustrated Guide to Conflict Resolution*
- *The Servant Manager: 203 Tips from the Best Places to Work in America*

The Collaboration Effect®

Overcoming Your Conflicts

Michael A. Gregory

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The Collaboration Effect

Build bridges to a common purpose by:

Connecting Relationships

Search social media
Network with others
Discover common interests

Listening Actively

Listen with 100% attention
Ask open-ended questions
Check for understanding

Educating Judiciously

Comment honestly and concretely
Stand ready in spirit of helpfulness
Demonstrate expertise humbly

Ten Steps to Interest-Based Solutions

1. **Define** the problem or issue and take on only one problem/issue at a time
2. **Listen** to understand the emotion and facts associated with the issue
3. **Identify** and clarify interests
4. **Generate** options
5. **Determine** the impacts of options
6. **Evaluate** the impacts of the options
7. **Select** a solution
8. **Consider** implementing the solution or return to an earlier step
9. **Consider** testing the solution before implementing the solution
10. **Consider** BATNA and WATNA if no solution can be found

Key Terms for Collaboration

Issues – Problems to be solved

Positions – Demands/statements of what someone says they will or will not do; one party's solution

Interests – Underlying needs, concerns, hopes, fears

Options – Possible - often creative - pieces of an agreement. Options are not commitments

Standards – Customary, objective, and widely-accepted criteria for handling similar situations

BATNA – Best Alternative to a Negotiated Agreement: One way to satisfy your interests if the negotiation fails

WATNA – Worst Alternative to a Negotiated Agreement: The worst possible outcome if negotiation fails

The Collaboration Effect

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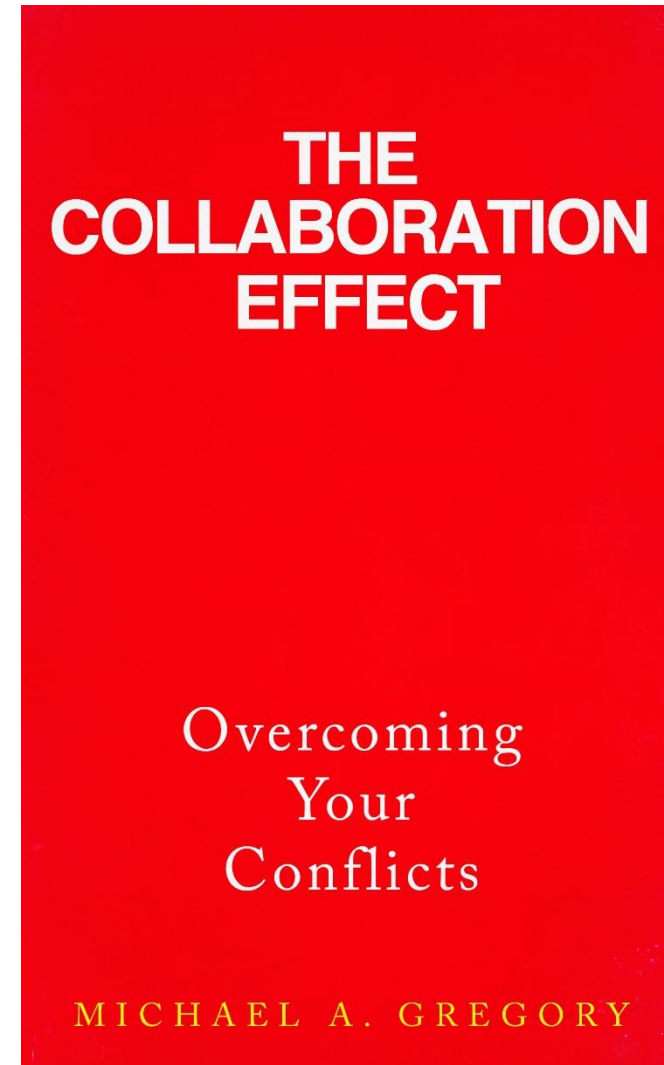
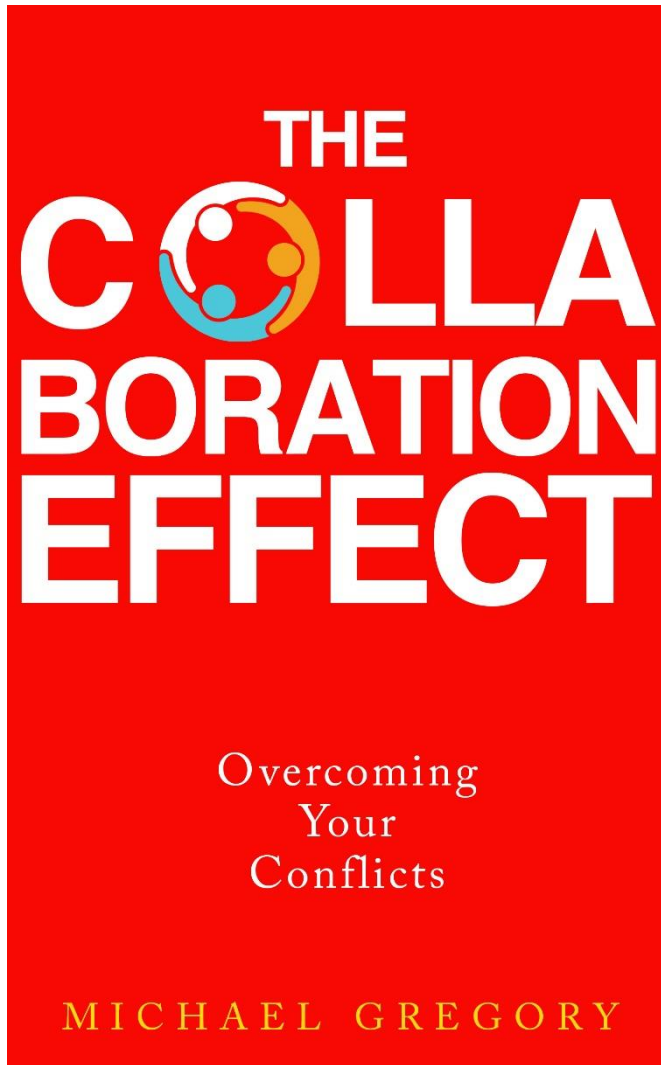
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Please Ask Your Questions?

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