

An aerial, high-angle photograph of a dense city skyline, likely New York City, with numerous skyscrapers and buildings. The image is overlaid with a semi-transparent dark blue filter. The text "BUSINESS VALUATION AND IRS DISPUTES" is centered over the image in a large, white, bold, sans-serif font.

BUSINESS VALUATION AND IRS DISPUTES

Taxes are an inevitable part of running a business. Most business owners are concerned about the possibility of an IRS dispute or audit. While audits are relatively rare for small businesses, they are more common for large companies. This means that as a business gets larger and profit increases, audit probability increases.

Strategies exist that can help business owners decrease their risk of being flagged for valuation-related audit and further inquiry by the IRS. These include a qualified appraisal by a qualified expert appraiser, adhering to industry-specific processes and documenting properly.

When a business is audited, despite these preparations, experience in working with the IRS will enhance the potential for resolution with the IRS or in tax court. The vast majority of cases resolve during the audit stage. In rare cases, some business owners may choose tax court. In these cases, a very specific set of strategies is needed to improve the likelihood of a successful resolution. This article explains the strategies a business can use to minimize the risk of being audited for inappropriate business valuation. We also review strategies for resolving IRS audits successfully, including tax court.

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AVOIDING IRS DISPUTES AND AUDITS

The best way to avoid an IRS audit is to prepare for one. Keep in mind that the business must strictly adhere to industry-recognized processes. These include an independent third-party appraiser, clear and concise reporting, prior relevant experience, and compliance with appraisal standards.

Comprehensive documentation of items like total fair market value, total number of shares, clearly defined subject interest, current business health, management, competition, future expectations, distributions, etc. offers valuation support and allows the IRS an ability to resolve without audit. Without this analysis, the IRS is virtually required to audit.

RESOLVING IRS DISPUTES AND AUDITS

Even with careful preparation, there is still a chance that a business will be audited. The following strategies can help a business successfully prepare and navigate the audit or dispute process, up to and including the rare cases that progress to tax court.

Deliver What the IRS is Looking For

In every case, the first step to resolve an audit or dispute successfully is to determine what information the IRS needs. This information should already be in the appraisal but the IRS may want to understand sensitivity to changing key assumptions. We help the IRS with this step to better understand the IRS position. Frequently, we are able to point the IRS to portions of the report that address the concern.

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For example, the IRS might be looking for additional documentation about factors considered in the company specific risk.

Once an appraiser understands what the IRS wants, it is important to deliver that information clearly and with as much supporting detail as possible. Even if the IRS doesn't accept the provided reasoning and documentation, it makes later stages much easier. In the event that the case does go to tax court, an established pattern of good-faith dialogue and cooperation is persuasive to most judges.

Document Everything

From the very beginning of a project, one of the most vital practices is to document everything. Document the valuation process and any other business processes or policies that might come under scrutiny. Part of our documentation process is to document documents that you do not have and do not use. We also document IRS communication, including the specific requests, the positions taken, and calls and meetings with the IRS. In court, if something isn't documented, it doesn't count.

The documentation strategy is effective against the IRS "shotgun" audit strategy. We frequently encounter IRS agents who meet with our clients and lay out a specific argument about why that client owes more taxes than they paid. When presented with a reasonable argument about why the tax paid was appropriate, the agents will often come to the next meeting with a completely different argument. This back and forth can be extremely frustrating, but documentation of the changing arguments and responses is a path to long-term success.

The IRS "shotgun" strategy is poorly received by the IRS legal team and tax court judges. IRS lawyers pick cases they can win. The shotgun strategy does not present well in tax court. Clients are better positioned for victory by documenting the IRS changing arguments and demands.

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Make a Reasonable Offer

At every stage, it's important to take reasonable, defensible positions with comprehensive documentation backup. Keep in mind that just because a position is reasonable doesn't necessitate that the IRS will think it is reasonable. In fact, there are some very reasonable market-oriented positions that IRS internal rules forbid.

Despite this reality, taking reasonable positions increases the likelihood that the IRS will ultimately agree. It also increases the chances that a tax court will rule in favor of the taxpayer.

Determine if Tax Court is a Viable Strategy

If during the course of the audit it appears that a resolution might be difficult, re-evaluate whether tax court is a viable strategy based on the value of the effort. The determination will impact negotiations and strategies moving forward.

The first consideration is cost. Tax court is expensive so should be considered a last resort for most taxpayers. Compare the amount of money the IRS claims the business owes against the estimated cost of taking the case to tax court. Even if the IRS claims the business owes several hundred thousand dollars, the cost, time, effort, and uncertainty of going to tax court will likely outweigh the benefit.

Other considerations include the business' audit history, the documentation available to create a strong case, and the argument the IRS is likely to present in court. An experienced tax attorney working closely with an experienced appraiser can guide you through these considerations in the unlikely event that a case cannot be resolved outside of tax court.

CASE STUDY

Most IRS audits and disputes are settled before they go to tax court. When they do, testimony tends to be limited. For these reasons, it's very rare for a business valuation professional to testify in tax court.

I joined the small group of professionals who have testified in tax court in 2016. I testified on behalf of the Cecil Family, which owns the Biltmore House and Gardens in Asheville, NC. If you have never been, you need to go. If you have visited previously, you know what I mean and are now thinking about a good time to return, right?

Adams Capital was brought in to opine on the value of an ownership interest in the business. We visited the property, reviewed relevant documents, met with family business stakeholders, spent hours with the family's attorneys, and thoroughly researched the industry and similar public companies.

We determined the business value and created robust documentation around the valuation. We anticipated questions that we knew the court was likely to ask, and anticipated the IRS arguments. At trial, I was called as an expert witness to explain how we arrived at our conclusion. We still are waiting on the tax court decision on this matter.

- David Adams, President of Adams Capital

EFFECTIVE SUPPORT FROM A BUSINESS VALUATION FIRM

By following rigorous documentation and industry-standard processes, many businesses can avoid IRS audits. In situations where an IRS audit occurs, businesses can increase their chances for a successful outcome by delivering what the IRS is looking for, documenting everything, taking reasonable positions, and honestly considering the viability of tax court. A business valuation professional can help guide your business through this process.

Adams Capital always offers a no-cost initial telephone consultation to provide a sounding board to business owners struggling with these difficult decisions.

Please email us at tara@adamscapital.com or call us directly at 770-432-0308 to schedule a consultation or to learn more.