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Gift, Estate, & Income Tax Valuation Insights Newsletter

Defensible Gift and Estate Tax Valuations

Reducing IRS Scrutiny

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Executive Summary

IRS scrutiny of gift and estate tax valuations typically arises not from a single issue, but from patterns of weak support, inconsistent assumptions, or a disconnect between the rights of the interest being valued and the conclusions reached. Examinations often focus on whether discounts for lack of marketability, tax affecting for pass-through entities, projected cash flows, growth rates, and discount rates are grounded in company-specific facts and supported by relevant capital market evidence. Valuations that fail to clearly tie empirical data to the economic realities of the subject interest are more likely to invite challenge.

At its core, a defensible valuation is defined by internal consistency, transparency, and analytical rigor. The narrative must align with the numbers, risk discussions must be reflected in the discount rate, and selected market multiples must reasonably account for differences in size, growth, and risk. When assumptions are clearly supported and the logic of the analysis can be followed from start to finish, the likelihood of IRS scrutiny is meaningfully reduced—and the valuation is far better positioned to withstand examination.

Introduction

High-quality, credible valuation work is best positioned to withstand an Internal Revenue Service examination. When scrutiny does arise, we are often asked to assist clients and their advisors in responding to IRS questions, information requests, and, in some cases, formal valuation disputes, in many instances when we were not the initial valuation provider.

Across our experiences, a consistent theme has emerged: IRS attention is usually not triggered by a single issue. More often, scrutiny arises from weakly supported assumptions, lack of capital market evidence to support key aspects of the valuation, misalignment between the narrative and the numbers, a faulty or non-existent reconciliation of value or other inconsistencies that undermine the credibility of the valuation as a whole. In gift and

estate tax matters in particular, IRS examinations often center on whether valuation judgments are supported by capital market evidence that is aligned with the economic benefits inherent in the subject interest. What follows is a discussion of common valuation issues that tend to attract IRS attention in the gift and estate tax context.

Rights and Benefits of the Subject Interest

A foundational issue that many times is not afforded proper attention is whether the valuation properly reflects the rights, benefits and attributes of the specific interest being valued. A valuation report should not only indicate the level of value of the interest (e.g., nonmarketable minority, marketable minority, or controlling interest), but should also clearly connect that conclusion to the rights afforded the interest by entity governing documents (or state statutes) and the interest's inherent control (or lack thereof) and marketability.

The rights of an interest, especially as they relate to voting powers, distribution rights, liquidation preferences, and transferability, may have a profound impact on value. An analysis that does not clearly identify those rights invites scrutiny. When a stated level of control is inconsistent with the actual voting, economic, or liquidation rights, the IRS is more likely to question the valuation framework from the outset. A defensible report not only precisely identifies the interest, but it also is explanatory as to control or lack thereof and the transferability associated with the interest (i.e., the rights the holder can exert).

Discounts for Lack of Marketability

The discount for lack of marketability remains a central point of IRS scrutiny, particularly where the magnitude of all applied discounts and resulting impact on value is material. While there is no definitive rule, higher allowance levels tend to invite closer review.

When referencing empirical studies under a qualitative approach, it is not sufficient to merely cite empirical studies if the relevance of those studies to the subject entity is not analyzed and adequately explained. Restricted stock studies, pre-IPO studies, and other empirical benchmarks must be tied to the specific facts of the entity: expected holding period, distribution policy, volatility, exit prospects, and the size and nature of the ownership block. Failing to link company-specific facts with the capital market evidence relied upon to support the discount may serve as an invitation to IRS scrutiny.

Similarly, when applying quantitative methods, care should be taken to ground key assumptions in the attributes of the company, the unique characteristics of the subject interest, and available market evidence.

In general, the IRS is less concerned with the use of any particular method than with whether the report demonstrates a clear analytical bridge between the data reviewed, how that data applies to the entity being valued, and the conclusion reached. Where the discount appears detached from the economics of the interest, questions follow.

Pass-Through Entity Tax Affecting

For S corporations, LLCs, and other pass-through entities, tax affecting continues to receive heightened attention, notwithstanding recent court opinions that have upheld tax affecting. When tax affecting is applied, it is critical to clearly present the justification for doing so. Reports that apply tax affecting mechanically, or without addressing the underlying economic rationale for doing so, are more likely to draw significant inquiry even when the resulting value appears reasonable. In addition to support for tax-affecting, it is also important to present the economic justification of whether pass-through entity status is a positive, negative or neutral attribute. Proper

support for tax-affecting and consideration of pass-through status from the perspective of a hypothetical willing buyer and seller is critical for the acceptance of value conclusions involving interests in pass-through entities.

Expected Cash Flows

Another common issue arises when the story of the entity in question does not align with the forecasted cash flows used in the valuation. Narratives that describe strong competitive positioning, pricing power, and growth opportunities cannot be paired with flat or declining cash flow forecasts without explanation. Conversely, significant earnings growth assumptions need to be supported by historical performance, industry conditions, reinvestment requirements, and operational capacity.

A fundamental expectation that underlies sound valuation analysis is that the qualitative discussion of the company's operations, strategy, and outlook will be consistent with the cash flows being valued. If the narrative and the numbers tell different stories, the conclusion of the appraisal may be called into question.

Growth Assumptions

Closely related to cash flows are growth assumptions, particularly long-term growth rates. Misalignment often occurs when the analysis emphasizes growth opportunities but applies very modest growth rates without explaining the disconnect. Other times, optimistic growth rates are selected without sufficient discussion of sustainability, competitive response, capital investment needs, or macroeconomic constraints. Long-term growth assumptions should be economically supportable and internally consistent with industry dynamics and broader economic expectations. Growth rates do not need to be either aggressive or scaled back to be credible, but they need to reflect realistic expectations. As always, the assumptions should be supported by relevant data and sufficient capital market evidence.

Discount Rates and Risk

The selection of a discount rate is another area where inconsistencies can attract IRS attention. It is essential that an appraisal include sufficient explanation and market-based support for the components of the discount rate, including any company-specific risk premium. Discount rates that do not reflect the risks described in the economic outlook, industry research, or company analysis can raise concerns. If the narrative highlights customer concentration, key-person dependency, cyclicality, or competitive threats, the discount rate should reflect those risks in a supportable way. The IRS often evaluates whether the discussion of risk logically supports the components of the discount rate, rather than focusing on any single numerical input. Transparency and support matter as much, if not more than, precision alone.

Market and Guideline Public Company Methods

When market-based approaches are used, the IRS closely reviews the comparability analysis. Issues frequently arise when multiples from transactions or guideline public companies differ materially from the selected multiples applied to the subject company without adequate adjustment or explanation. Both qualitative and quantitative differences in size, margins, growth prospects, capital structure, or risk profile should be acknowledged and analyzed.

Selected multiples should be consistent with the investment risk of the subject entity. If the subject company is smaller, less diversified, or riskier than the guideline set, the selected multiple should reflect that reality, and the rationale should be explained. The expectation is not perfect comparability, but rather a transparent explanation

of why the selected multiples appropriately reflect the investment risk of the interest being valued relative to the guideline multiples given the differences observed.

Final Considerations

Beyond any single technical issue, IRS scrutiny often increases when reports lack internal consistency. Assumptions stated in one section should align with those applied in later sections. Descriptions of control should match the treatment of discounts. Risk factors discussed qualitatively should be reflected quantitatively, and vice versa.

A reader of a valuation report (whether an IRS examiner or another advisor) should be able to replicate the logic and analysis from start to finish. Every appraisal should feature assumptions supported by market data and sound judgment. When the story and the numbers align, the likelihood of IRS scrutiny is meaningfully reduced, resulting in accepted as filed outcomes. In the event scrutiny does occur, those same characteristics of a well-supported valuation place taxpayers and their advisors in a much stronger position to defend the valuation.

Ultimately, defensible gift and estate tax valuations are not defined by any single assumption or technique, but by integrity related to the totality of the analysis and reporting. For estate planners and attorneys, a proactive approach involving early coordination with valuation professionals who focus on valuation for estate planning purposes can materially reduce downstream risk. This is of particular importance prior to structuring transfers, drafting governing documents, or contemplating the transfer of minority interests in closely-held business entities that involve significant discounts. If you are planning a transfer, reviewing an existing appraisal, or anticipating potential IRS review, we would welcome the opportunity to discuss how to position the valuation for durability and defensibility from the outset.

Upcoming Conferences

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2026 ACTEC Annual Meeting

Hosted by The American College of Trust and Estate Counsel

March 4-8, 2026 | Tampa Bay, FL

- Timothy K. Bronza, CPA, ASA
- Travis W. Harms, CFA, CPA/ABV
- Thomas C. Insalaco, CFA, ASA

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Transitions 2026 Spring Conference

Sponsored by Family Business Magazine

March 18-20, 2026 | St. Petersburg, FL

- Travis W. Harms, CFA, CPA, ABV

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Florida Tax Institute

April 8-10, 2026 | Orlando, FL

- Timothy K. Bronza, CPA, ASA
- Thomas C. Insalaco, CFA, ASA
- Barbara Walters Price

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Texas Bar Association Advanced Estate Planning Strategies 2026

April 23-24, 2026 | Boulder, CO

- J. David Smith, CFA, ASA
- Barbara Walters Price

Valuations are a critical element of successful tax planning strategies and objective third-party valuation opinions are vital.

Business valuations prepared for federal tax transactions are at the core of Mercer Capital's valuation practice. Since 1982, we have been providing objective valuations for federal estate, gift, income tax, and corporate transactional matters. We are recognized experts in this challenging area of valuation practice.

Mercer Capital is one of the largest independent business valuation and transaction advisory firms in the nation, with a deep bench of seasoned professionals. We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. With the size of our staff and the firm's technical and project management expertise, we can handle projects of any size, no matter how complex.

And we understand what the IRS considers important. From corporate income tax planning to transfer tax planning and administration, a federal tax valuation plays a central role in positioning your or your client's business for success. That is why we take great care to ensure our federal tax valuations are substantiated and well-documented, enabling you to implement effective planning strategies with confidence.

Gift, Estate, and Income Tax Valuation Services

Estate and Gift Tax Transactions

- Estate Tax Administration and Reporting – IRC §2031
- Estate & Gift Tax Controversies – Valuation Consulting
- Gift Tax Planning & Reporting – IRC §2512
- Pre-Expatriation Planning & Reporting

Income Tax Transactions

- Allocation of Value, Determination of Professional Goodwill
- Charitable Contributions – Reg. §1.170A – 13(c)(2)
- Compensation in Kind – Reg. §1.61-2(d)(1)
- Compensation Planning – IRC §§83(b) and 409(A)
- Corporate Reorganizations
- C Corporation to S Conversion – IRC §1374
- Divestitures
- Expatriation Tax Reporting – IRC §877A
- Income Tax Controversies – Valuation Consulting
- Net Operating Loss (NOL) Carryforwards – IRC §382
- Not-For-Profit – IRC §501(c)(3)
- Qualified Stock Purchases – IRC §§351, 352, and 338
- Worthless Securities – IRC §165
- Valuation of Closely Held Securities Held by a Stock Bonus, Pension or Profit-Sharing Plan of an Employer – IRC §401(a)(28)(C)

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