

Business Valuation Notes

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IRS DEFERS STOCK COMPENSATION RULES

The United States Treasury Department and the Internal Revenue Service (IRS) have announced a one-year deferral to comply with compensation reporting regulations set forth under Section 409A of the Internal Revenue Code. Plans and arrangement had been required to comply by December 31, 2007; IRS Notice 2007-78 now extends the document compliance deadline to December 31, 2008. The extension should assist companies to gather documentation for reporting.

MBVG President Randall Schostag said he wasn't surprised by the announcement. However, Schostag cautioned companies with this form of compensation not to simply delay the beginning of adoption, but to start now going through the learning required. "As we've learned with the Statement of Financial Accounting Standard 123 (R), many clients are going to discover that their bookkeeping has been inadequate to easily find the necessary information to properly calculate this compensation cost," Schostag said. "Companies should use this time to get their records together."

The IRS notice extends the compliance deadline and also provides for additional limited transaction relief. However, the notice does not postpone a January 1, 2008 effective date for the final regulations. It's expected that the Treasury and IRS will issue further guidance with a limited voluntary compliance program to permit taxpayers to correct certain unintentional operational violations under the section and thereby

limit the amount of additional taxes due.

Business Valuation Notes first discussed 409A in the January 2006 issue. The article summarized changes to equity-based compensation made during 2005 relative to new tax regulations for stock and stock options or "Share-Based Payments" used in lieu of cash for compensation. The expensing of stock-based compensation changes in expensing were ushered in by SFAS 123(R) effective for the fiscal year beginning after June 15, 2005, and relates specifically to employees. Section 409A was introduced by the American Jobs Creation Act of 2004 for tax years after December 31, 2004. The rules impact equity compensation arrangements, including stock options, stock appreciation rights or SARs, phantom stock, restricted stock units, supplemental retirement programs, and other promises to pay compensation in the future, such as guaranteed severance payments in addition to standard deferred compensation plans.

Business Valuation Notes also discussed the importance of proper valuation in an article in the December 2006 issue, citing a study by the National Center for Employee Ownership (NCEO), May 30, 2006, in which the authors asserted that companies were undervaluing the compensation they were issu-

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The Fed & Markets INTEREST RATES IMPACT VALUE

"The flight to quality in US Treasuries that has occurred as a result of the credit-chaos has created distortions in the valuation models used by man," according to Vinny Catalano, Chartered Financial Analyst (CFA), President of Blue Marble Research.

Catalano says, "The obvious direct effect [of the flight to quality] is to drive down the interest rate component of valuation models and, thereby, drive up the fair value estimates of equities."



Catalano

MBVG Vice President Steve Sarracco explained that when using the income approach to value a security, the discount rate used to bring future expected earnings and cash flow to net present value consists in part on the risk-free rate of interest determined by using US Treasury securities.

"Cost of capital includes the rate of risk free interest," Sarracco said. "The lower the interest rate, the lower the cost of capital and the higher the value of the security in present dollars." The most frequent model used by analysts incorporating these factors is the discounted cash flow model. This model discounts expected future cash flow earned to net present value after adjusting for risk. (Continued on page 2)



Sarracco



Schostag

MARKETS

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MBVG analyst Joel Grundmeier notes that issues such as that raised by Catalano are important to consider when conducting a valuation. "Valuation requires more than just a 'black box' approach of plugging in numbers and getting an answer," Grundmeier said. "You really have to think through the implications of the data you're supplied."

US treasuries and bonds are normally used as a proxy to determine the risk free interest rate portion of expected risk. A flight to quality means that investors are avoiding, for example, corporate debt in favor of lower yielding government debt because there is no risk of failure to repay. If the decline in the risk free rate is a result of a flight to quality, two questions must be considered, according to Catalano: is the flight to quality temporary, and should adjustments be made to the valuation models used.

"If the answer to the first question is yes, then the answer to the second question is also yes," Catalano says. "If so, then the impact would be an increase in the interest rate component and a downward revision in the fair value calculations."

What exactly that adjustment would be is a matter of judgment, Catalano admits. For example, some form of normalization could be employed in which the average of, say, the 10 year US Treasury rate would be used versus the current level. If the answer to the first question is no, however, then a serious review of earnings expectations must be considered as the expected return to fair value is extraordinarily high.

In his work Catalano is also Global Investment Strategist and offers advice and recommendations for investors. He is the author of "Sectors & Styles: A New Approach to Outperforming the Market." Catalano is a past president of the New York Society of Security Analysts and he appears

regularly on TV including CNBC's "Morning Call" and "Kudlow & Company", Canada's leading business network "Business News Network" (BNN), New Delhi TV, Forbes.com's MoneyMasters, and on various business radio programs. He is frequently quoted in professional publications, such as the *Wall Street Journal*, the *Financial Times*, Barrons, the *Globe and Mail*, and *Business Week*, among others.

Catalano's "Sectors & Styles" was published by Wiley Finance in May 2006 (ISBN-10: 0471758825). As the title implies, the book relates to investing using information about market sectors, rather than picking single stocks. His emphasis refers to Exchange Traded Funds (EFT) for investors to ensure diversification. He publishes a daily blog – *Musing on the Markets* - providing his opinion on market conditions at <http://vinnycatalano.blogspot.com>.

"An important thing to consider is that when developing a discount rate, the appraiser must examine the time duration or expected holding period of an investment," Grundmeier said. "For example, if you assume that an investor is in for the long term, you are likely to use 20-year bonds rather than 10-year treasuries for the rate. In any event, you don't want to accept any rate without understanding the surrounding environment."

DLOM REQUIRES REASONING

In a recent Federal case the court dismissed the opinion of two experts, including Mukesh Bajaj, Ph.D., regarding an appropriate marketability discount for restricted stock, and instead chose an expert opinion because his opinion was 'more well-reasoned', thus allowing discounts of from 22% for one year to 50% for four years. This was in contrast to the other two appraisers who had indications of about 20%, regardless of time.

The case was David S. and Malia A. Litman, Plaintiffs – Counterdefendants, v.

The United States, Defendant. The case also involved Robert B. and Michelle S. Diener, Plaintiffs – Counterdefendants, v. The United States, Defendant, and Hotels.com, Inc. and Subsidiaries, Plaintiffs, v. The United States, Defendant: Nos. 05-956T, 05-971T & 06-285T, United States Court of Federal Claims, August 22, 2007.

The case arose from the failure of taxpayers to reach an agreement on the value of almost 10 million shares of restricted stock issued in February 2000 to the Litmans and the Dieners, founders of Hotels.com, Inc., and subsidiaries' two predecessor companies, TMF, Inc. and HRN Marketing Corp. (HRN Marketing). The written opinion concerns the valuation of HRN.

The Litmans and the Dieners presented on expert witness: Mark L. Mitchell, CFA, ASA, Director of Valuation Services for Clothier & Head, P.S., an accounting firm. Hotels.com offered one expert witness, Dr. Mukesh Bajaj, a Senior Managing Director of Finance and Damages Practice at LECG, LLC, an international consulting firm. Testifying for the defendant was one expert witness, Francis X. Burns, ASA, a Vice President of CRA International, a publicly traded consulting firm focusing on economic analysis, valuation work, and strategy consulting.

Minnesota Business Valuation Group President Randall Schostag said that the case was interesting in again demonstrating that the most important element in valuation is to use methods which have been accepted within the valuation community and also to display thoughtful work to arrive at a value. Schostag considered the case also interesting, however, in that the opinion of Bajaj was disregarded in favor of the opinion of Mitchell.

"Bajaj came into notoriety in the valuation community when a case he represented was determined in his favor in *Gross v. Commissioner*, 2001 U.S. App., (6th Cir., Nov. 19, 2001). In that case the court chose to disallow tax affecting a business with an S cor

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IRS

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ing by about 50%.

The adoption of both SFAS 123 (R) and IRS Code Section 409(A) has increased the cost of not correctly valuing the options. If a deferred compensation arrangement is subject to 409(A) and fails to comply with the new rules, there is a possible double punch. First, any amount deferred will be taxable in the year it was initially deferred, and second, the amount will be subject to an additional 20% tax, plus interest.

“Under SFAS 123(R), companies often have done the work themselves,” Schostag said. “But with penalties under 409A, that work is most certainly going to certified appraisers.”

Citing a recent example, Schostag said that even companies with strong accounting are discovering that their records of stock options after grants are made are difficult to reconstruct for purposes of ascertaining forfeiture rates and expected life. “The historical rate of forfeiture to vesting is best obtained by a review of past grants,” Schostag said. “But surprisingly, many companies are unable to easily assemble records of individual employees, the date of grant, the date of forfeiture, and the date of exercise or forfeiture either before or after vesting. Yet these records are necessary for establishing reasonable rates of forfeiture for new grants and the expected life to be used for option pricing.”

In the November 2006 *Business Valuation Notes*, MBVG reported on a new public law relating to pensions and changes in Internal Revenue Service definitions which have refined the definition of a qualified appraiser and a qualified appraisal. The IRS issued Internal Revenue Bulletin 2006-46. The changes ensure that appraisals for tax purposes are done by an analyst who is qualified, and also levies hefty penalties to appraisers whose opinion is found in substantive error and without foundation.

In September 2006 the Pension Protection Act of 2006 was signed into law. Section 1219 of the law changed appraisal requirements for tax purposes in two areas: Under Section 170 of the

Internal Revenue Code the definitions of Qualified Appraisal and Qualified Appraiser were changed. The definition of Qualified Appraisal now refers to “generally accepted appraisal standards. And the definition of a Qualified Appraiser now includes the term “earned an appraisal designation from recognized professional organization.”

The legal precedent was established under Khumo Tire and Daubert requiring appraisers to use methods which have been accepted by the appraisal community. If the methods used have not been reviewed and accepted by others in the appraisal community, there has been a chance that an appraisal opinion may be thrown out of court. The Minnesota Business Valuation Group considers the new measures passed to codify what common law has already set.

The Internal Revenue Code referenced is Code Section 6695A applies to anyone preparing an appraisal who knows or reasonably should have known that the appraisal would be used in connection with a tax return or claim for refund. In this regard, an attorney, tax preparer-CPA, or even an executor could be deemed an appraiser. Any appraiser who submits an appraisal with a “substantial” or “gross” misstatement of value may be subject to a penalty payable by the appraiser based on the lower of two factors: 1. \$1,000 or 10% of the tax underpayment (whichever is greater), or (2) 125% of the appraisal fee.

It’s expected that the appraiser will incur the liability of a fine (a nondeductible penalty) of 125% of their fee. A substantial misstatement of value is defined as 150% of the amount ultimately determined to be the correct value (for overvaluation), or 40% of the amount ultimately determined to be the correct value (for undervaluation).

These provisions apply to both income tax and transfer tax issues, including: charitable gifts, income tax deductions, estate taxes, gift taxes, and the like. The new penalty does not appear to apply to appraisals for the purpose of existing tax litigation support, such as expert witnesses engaged after the tax return was filed. Adoption of these definitions and penalties increases the risk to appraisers and their potential liability. There is a

possibility of an appraiser induced penalty even if that person or institution did not know or realize at the time of the appraisal that the work could result in an underpayment of tax.

Schostag said that MBVG was recently engaged in a matter of evaluating the price per share a company developed internally at the time when an employee exercised non qualified options in a private company. The company reported a per share value to the IRS as required, thus triggering a tax liability for the employee, the difference between the exercise and the fair market value of the stock. The company went public a short time later at a price per share which was much lower than the value reported for tax purposes. The company’s determination of value for the privately held securities thus increased the tax liability for the employee while decreasing taxable income for the company. “This is a good example of why it is critical for companies to use a certified appraiser,” Schostag said. “The valuation notes obtained from a memo issued by the company failed to disclose methodology which MBVG believes is accepted within the valuation industry.”

Up until the change, Section 6701 of the code allowed the IRS to impose a penalty only if the appraiser knew it would result in an underpayment, i.e. colluded with the taxpayer. Previously the IRS had the burden of proof; now the burden of proof has shifted to the appraiser and taxpayer. The only way to avoid the penalty is by appeal to the Treasury Department, which is the same regulator which may impose the penalty. Appraisers are now subject to the same criteria as lawyers and accountants for IRS practice as set forth in Circular 230.

With these rules appraisers may be blacklisted from ever again being able to present expert testimony before the Treasury or IRS proceedings. According to notice 2006-96; 2006-46 IRB 1, tax returns filed after February 16, 2007, must include a statement that the appraiser understands that an appraisal resulting in substantial or gross valuation misstatement may be subject to the penalty

DLOM

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poration election for a valuation, thus increasing the value for tax purposes considerably. Until that decision, tax affecting a business as if a C corporation was generally accepted within the valuation community. Within the valuation community the general opinion was that Bajaj had not considered important elements accepted within the community and, therefore, he attained a certain unpopular status.

“The tax case which made Bajaj’s name prominent was significant, in my opinion, because it raised important questions about the added value of a tax flow entity which had not been previously considered,” Schostag said. “Bajaj offered reasoning in that case which had not been weighed by appraisers. Since that case and due to the findings, the valuation community has become more sophisticated about tax affecting, including understanding that the value of a pass-through entity can be either great than or less than that of a C corporation, depending on the amount of dividend or shareholder payout.”

Schostag said the strength of Bajaj in the *Gross* case appeared to be his weakness in the *Litman* case. “Bajaj and the other appraiser simply didn’t display the same in-depth reasoning as Mitchell,” Schostag said. “The appraiser is there as an expert to help the fact finder determine a reasonable finding. He is not an advocate, per se, for the client.”

The court was faced with determining the appropriate marketability discount of restricted stock from HRN. Mitchell used a Black-Scholes (option) method, CAPM (Capital Asset Pricing Model), the Hertz and Smith Study, and the Silber Study to develop a marketability discount for the restricted stock. Bajaj relied on a study he co-authored in 2001 with two other authors and compared the result with FMV data. Burns used a restricted stock approach and an option approach. Importantly, Mitchell also considered the size of the block of stock and determined that a block discount was in order.

In prior newsletters MBVG has discussed the importance of examining the size of a block of stock, citing empirical analysis which can be obtained using the Abbott Index, a way of assessing the amount of discount which has been developed by MBVG Principal Dr. Ashok Abbott, West Virginia University. The Abbott Index also considers the security’s volatility and expected time to liquidation, as was done in this case by Mitchell.

In arriving at a conclusion, the court noted that Burns’ use of information relied primarily on differences in marketability by comparing HRN’s earnings and revenues to each study’s data. While the court agreed these are two factors that should be considered, they are not the only factors that should be considered.

The court was critical that Bajaj did not take into account the substantial restrictions imposed on the restricted stock, noting that the stocks in the Bajaj study and the FMV study could be sold into private placements, could be collared, and were not subject to Rule 144 trade-volume restrictions. None of these alternative means to achieve liquidity were available for the subject shares.

The court further noted that Bajaj had not adjusted his marketability discount for the fact that the plaintiffs were CEO and President with the not unlikely consequence that in marketing their shares the price may be depressed as a result of other investors interpreting any sale as a sign that a sell-off by these officers would portend.

Jerry Marlow’s Offerings...

OPTION S MANY APPLICATIONS

A long-time friend of the Minnesota Business Valuation Group has turned his knowledge of corporate finance and free lance writing toward assisting appraisers and clients to understanding option theory for valuation support.

Jerry Marlow, MBA, has started teaching understanding option pricing with a class on option pricing in a litigation setting: <http://www.jerrymarlow.com/divorce/index.htm#Seminar>.

MBVG was introduced to Marlow in 2001 when he published *Option Pricing, Black-Scholes Made Easy* (Wiley & Sons, 2001, ISBN 0-471-43641-0). MBVG considers this an easy way to learn application of options without complicated math contained in most presentations. In early 2002 MBVG sponsored a web-cast for Marlow for colleagues who were interested in finding a less complex system than was available.

Since MBVG’s first joint projects with Marlow he has other presentations of his system and has developed additional software and services for higher end users, including divorce support and hedge fund tools.

Marlow says, “Black-Scholes option pricing theory has revolutionized financial thinking. Every financial forecast over a specific time horizon is a probability distribution. To value an investment is to evaluate that distribution.”

Marlow admits that to the uninitiated, modeling price evolutions and probability distributions is esoteric.

“Yet it is the ability to model price evolutions and formulate, analyze and compare probability distributions that allows us to determine if securities are undervalued, fairly valued or overvalued,” according to Marlow.

Many hedge funds base option-trading strategies on if the forecast for a security or index agrees with the market-equilibrium forecast implied in the market prices of options.

If the probability distribution disagrees with the market-equilibrium distribution, then you can take a combination of option positions that exploits the differences. If the portfolio manager’s probability distribution is better than the market-equilibrium probability distribution, you can make a lot of money quickly.

“Financial modeling drives trading strategies, decisions and the profitability of investments,” Marlow says.

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BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

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PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.