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# THE HEMPSTEAD LETTER

## Valuation Edition

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Vol. XXV, No. 1

### § 409A Stock Option Valuation Regulations Issued

On April 10, 2007, the Treasury Department and the IRS issued final regulations on the treatment of nonqualified deferred compensation plans under Section 409A of the Internal Revenue Code. Affected plans are required to comply with the documentation requirements established by these regulations by December 31, 2007. We will summarize below the portion of the regulations that applies to stock option exercise price valuations. A copy of the regulations, all 93 pages, can be accessed through our web site at [www.hempsteadco.com](http://www.hempsteadco.com).

#### **Options as Deferred Compensation**

Section 409A provides that an option granted with an exercise price less than fair market value as of the date of the grant is a deferred compensation arrangement. The recipient of such an option is subject to the following adverse tax consequences: (a) taxation at the time of vesting, and (b) a 20% tax penalty in addition to income taxes. There has been great uncertainty, prior to the issuance of these regulations, as to how private companies should value their stock when issuing options in order to avoid these significant adverse tax consequences. Now we have some help.

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**Section 409A provides that an option granted with an exercise price less than fair market value as of the date of the grant is a deferred compensation arrangement.**

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#### **General Principles**

The valuation guidance provided by the new regulations includes the following general principles:

“the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method... Factors to be considered... include... the value of the tangible and intangible assets of the corporation, the present value of anticipated future cash flows of the corporation, the market value of stock or equity interests in similar corporations and entities engaged in trades or businesses substantially similar to those engaged in by the [subject] corporation, ... recent arm’s length transac-

tions involving the sale or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes[.]” §1.409A-1(b)(5)(iv)(B)(I)

The regulation goes on to say that the valuation method will not be considered reasonable if it does not take into consideration all available information material to the value of the corporation.

#### **Valuation Safe Harbor**

The regulations describe circumstances under which a valuation will be accorded a “presumption of reasonableness” by the IRS. The use of any of the following methods is presumed to result in a reasonable valuation:

- A valuation that is not more than 12 months old and is prepared by an independent appraiser.
- A valuation based on a formula which is used consistently by the company and by all of its 10% plus shareholders for all restricted stock transactions (except for a sale of control).
- For start-up companies (non-public and in business less than 10 years), a written valuation report pre-

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#### **Revised Valuation Guidelines for Private Equity Issued**

The Private Equity Industry Guidelines Group (PEIGG) recently issued a revised version of its U. S. Private Equity Valuation Guidelines. The revised Guidelines, issued in March 2007, provide guidance to private equity funds on how to value their portfolio investments. A copy of the Guidelines can be found at: [http://peigg.org/images/2007\\_March\\_Updated\\_US\\_PE\\_Valuation\\_Guidelines.pdf](http://peigg.org/images/2007_March_Updated_US_PE_Valuation_Guidelines.pdf).

#### **GAAP Requires Fair Value**

Generally accepted accounting principles (GAAP)

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## ***§409A Stock Option Valuation Regulations Issued***

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pared by a person that the corporation reasonably determines is “qualified” to perform the valuation, based on the person’s significant knowledge, experience, education or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the company operates. The written

report must take into account the factors listed under **General Principles** above. The presumption of reasonableness will not apply to the valuation if the company or the option holder may reasonably anticipate, as of the time the valuation is applied, that the company will undergo a change of control event within 90 days, or make a public offering within 180 days.

The Commissioner may rebut the presumption of reasonableness upon a showing that either the valuation method or the application of the method was “grossly unreasonable”.

### ***Conclusion***

Section 409A has changed the landscape in which private companies issue stock options. There is no one pricing or valuation answer applicable to all issuers. Please consider Hempstead & Co. a resource when valuation questions arise. ■

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## ***Revised Valuation Guidelines for Private Equity Issued***

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require private equity funds to report portfolio investments on their financial statements at “fair value.” Until recently, however, there was no authoritative guidance on how to determine the fair value of an investment. The PEIGG was formed in February 2002, and is comprised of a volunteer group of private equity industry representatives who came together to establish a set of reporting guidelines for the industry. The Group is a broad-based alliance, consisting of general partners (managers), limited partners (investors) and service providers from both the venture and buyout segments of the private equity industry. It issued its initial Private Equity Valuation Guidelines in 2003.

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***Generally accepted accounting principles (GAAP) require private equity funds to report portfolio investments on their financial statements at “fair value.”***

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The recent revision to the Guidelines was prompted in large measure by the issuance in September 2006 by the Financial Accounting Standards Board (FASB) of Statement No. 157. The purpose of FASB 157 was to clarify the meaning of “fair value” for GAAP financial reporting purposes. PEIGG felt it appropriate to make modifications to its guidelines to ensure compliance with FASB 157.

### ***Definition of Fair Value***

The new PEIGG Guidelines have adopted the GAAP definition of fair value, viz. **“the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”**

The exit value emphasis of FASB 157 is of particular interest to the private equity industry because private equity funds have traditionally tended to value investments at cost and make adjustments only in connection with subsequent financing rounds or achievement of milestones. The revised Guidelines stress that the initial cost of the investment and the price of the most recent round of financing are factors that may be considered, but they lose reliability over time and must be evaluated in connection with other factors.

### ***Guideline Recommendations***

Unrestricted actively-traded public securities are required, in general, to be valued at the closing price or bid price. Discounts for blockage for unrestricted securities owing to the size of the holding are prohibited.

A discount from actively-traded values should be taken for securities which are subject to a formal restriction that limits their sale. Examples of such restrictions would include Rule 144 holding periods and underwriter’s lockups. Such discounts typically range from 0% to 30%. The size of the discount will vary depending,

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## ***Revised Valuation Guidelines for Private Equity Issued***

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among other things, on the length of the holding period.

Limitations on sale based on Rule 144's volume test or based on a closed trading window for board members do not qualify as formal restrictions related to the security itself. Therefore, discounts are not allowed in these situations.

In valuing non-actively-traded securities, the Guidelines encourage the use of a market approach in most situations, utilizing comparable company transactions or performance multiple inputs as the primary technique.

The Guidelines concede that there are other valuation

methodologies that may be appropriate in certain circumstances, including discounting cash flow, valuing net assets, and industry-specific benchmarking.

The Guidelines recommend that valuations be conducted or updated on a (typically) quarterly basis, subject to written parameters established in consultation with a Valuation Policy Committee composed of fund investors.

Finally, the Guidelines point out that they are not intended to eliminate all subjectivity. They are designed to provide a valuation framework while allowing a manager to exercise his best judgment in applying it. ■

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## ***FLP Discount Nixed by Pennsylvania Court***

The Commonwealth Court of Pennsylvania upheld a lower court decision which disallowed an inheritance tax valuation discount on a family limited partnership which had been accepted by the IRS. *2007 Pa. Commw. LEXIS 182, In Re The Estate of Helen H. Berry, Deceased Late of Venango County Pennsylvania, Appellant, No. 1485 C.D. 2006 (COMMONWEALTH COURT OF PENNSYLVANIA April 24, 2007)*

### ***The Partnership***

The Estate of Helen H. Berry included an interest in a family limited partnership (FLP).

The partnership interest had a net asset value of \$2,880,000, consisting of cash and marketable securities.

Following her death, on March 30, 2003, the Estate's executors filed both a Federal Estate Tax return and a Pennsylvania Inheritance Tax return. In valuing the FLP for the returns, the executors applied a 33% discount to the asset value for lack of control and marketability. The IRS accepted the Federal Estate Tax return as submitted by the executors, allowing the 33% discount. The Pennsylvania Department of Revenue, on the other hand, disallowed the discount.

### ***The First Two Appeals***

The Estate appealed the Department's decision to the Board of Appeals, which upheld the Department of Revenue's finding. The Estate appealed from that decision to the Venango County Orphan's Court, which found that the FLP did not operate as a legitimate business enterprise and refused to reverse the Board of Appeals.

### ***The Third Appeal***

The Estate appealed this decision to the Commonwealth Court of Pennsylvania. The Estate raised two issues for review: 1) whether the FLP serves a legitimate business purpose, and 2) whether the trial court erred in refusing to reverse the Department of Revenue's decision to disallow the valuation discount despite the fact that the IRS had allowed it.

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### ***The Estate argued that the fact that the IRS allowed the discount is dispositive.***

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Both parties agreed that there are no Pennsylvania Department of Revenue regulations pertaining to family limited partnerships and that, typically, the Department uses criteria that mirror those of the IRS when there is no applicable state regulation. The Estate argued that the fact that the IRS allowed the discount is dispositive.

### ***The Decision***

The Commonwealth Court disagreed. While agreeing that it is appropriate to use the same regulations that the IRS used in making the determination, the Court said that "The conclusion that the IRS reached, however, . . . is binding neither upon the Board nor upon this Court."

Finding itself not bound by the IRS decision, the Court then turned to address the Board's finding that the FLP served no legitimate business purpose. It considered the testimony of the family's CPA to the effect that the purpose of the FLP was to shield assets from liability, preserve the decedent's estate and save tax dollars. The

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## ***FLP Discount Nixed by Pennsylvania Court***

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Partnership Agreement, in its statement of purpose, was in accordance with this testimony. The Court noted that the only activity of the partnership was the sale of stocks to fund Decedent's distribution of the partnership's assets, and that Decedent remained the principal economic beneficiary of her contributed property, withdrawing cash from the partnership for personal use and for the bestowal of gifts

The Court concluded as follows; "There is sufficient record evidence to support the trial court's factual findings that (the FLP) did not operate as a legitimate business enterprise. The trial court did not err as a matter of law in affirming the Board." ■

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***We'd like to hear from you!*** Please contact us regarding information found in *The Hempstead Letter*, or with any mailing address updates.

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