

A New Landmark: Cases Considering Restricted Stock Discounts

Litman v. United States, 2007 U.S. Claims LEXIS 273 (August 22, 2007)

Not since the Estate of Gimbel v. Commissioner (2006) has a federal court taken such a close and comprehensive look at the calculation of marketability discounts for large blocks of restricted stock. In Litman, the Court considered an emerging Internet company's transfer of nearly 10 million shares to insiders (about 33% more than the public float) on the eve of its IPO, with the stock subject to considerable contractual and non-contractual (SEC) restrictions, as well as market, industry, and company risk.

Two business partners, Litman and Diener, began Hotel Reservations Network (HRN). In 1998, USA Networks bought 90% of the company for \$150 million. The partners remained in key executive roles; the buyout permitted them to sell their residual 10% interest over five years, with the price of the "earn outs" dependent on HRN's future performance. The agreement also allowed HRN to amortize the purchase price over a certain period of time, recapturing some of its costs through tax benefits (the "tax shield").

The company authorized an IPO only seven months after the sale and the parties agreed to convert the founders' earn out rights to equity. On February 24, 2000, the IPO price was set at \$16 per share, and HRN issued nearly 10 million shares to the former owners, subject to four years of restrictions: 40% transferable after the first anniversary of the IPO, 10% after each of the second and third anniversaries, and all remaining stock after the fourth. The IPO of 6.21 million shares closed on March 1, 2000 at \$26.25 per share.

In connection with their 2000 personal income tax returns, the former owners retained an accredited financial analyst to value the HRN stock. The expert began with the \$16 IPO price and then applied a discount for lack of marketability (DLOM) for each restricted "tranche" ranging from 49.5% in year one to 79% in year four for an average weighted value of \$4.54 per share.

On its 2000 corporate income tax return, HRN valued the shares at \$23 per share without applying

discounts, resulting in a goodwill value of nearly \$160 million, amortized in 2000 at \$9.5 million. The tax gap between the individual and corporate taxpayers amounted to approximately \$115 million.

Based on its own assessment, the IRS claimed a total of \$5.7 million against the former owners on their individual returns and \$3.2 million against HRN. By its notices of deficiency, the IRS also sought the "consistent and proper taxation of the transfer of the HRN restricted stock."

Key issues: valuation date and discounts

The U.S. Court of Claims first considered the appropriate valuation date. The IRS agreed with Litman and Diener that the appropriate date was February 24, 2000, when the IPO price was set and the issuer transferred the stock. All parties disagreed to the appropriate determination of discounts.

The IRS expert reviewed three restricted stock studies to establish a preliminary discount range from 16% to 22%, adjusted to 20% to 26% to account for the four-year restrictions. He also considered a "hypothetical equity option collar transaction," which encompassed four years of theoretical borrowing costs adjusted to present value. After adjustments to account for a "key person" discount, the IRS expert determined discounts for each tranche of shares, ranging from approximately 17% to 21%. He then

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compared both methods to reach a final weighted average DLOM of 20.3%.

The company's expert relied on a restricted stock study and a pre-IPO study and compared the length of HRN restrictions against large blocks of publicly traded restricted shares, using the latter's discounts as benchmarks. Ultimately, he concluded that a 20% DLOM was appropriate.

The taxpayers' expert reviewed the IRS Revenue Ruling 59-60 factors specific to valuation of restricted securities, concluding that the key "drivers" of marketability discounts were the substantial restrictions and the associated opportunity costs. Not only was the HRN stock restricted for twice as long as the more typical two-year holding period, but additional contractual limitations precluded private placement. The block was also larger than the public "float" of 6.2 million shares, further impacting the stockholders' ability to sell. The "frenzy" over Internet stocks was a final factor: during the two years prior to 2000, the return on public equity in the dot com sector was over 1000%.

To quantify these variables, the taxpayers' expert applied: (1) the Black-Scholes option-pricing model; (2) a capital asset pricing model (CAPM); and (3) a number of empirical studies. The latter gave rise to a range of DLOM from 31% in year one to nearly 70% in year four. Given the atypical restrictions and risk, the expert put greater weight on the pricing models to determine a final DLOM range of 49.5% to 79%.

The studies relied on by the individual taxpayers' expert helped support the conclusion that a "wide range of...marketability discounts" applied in this case, the Court said. "Also, these studies reinforce the concept that one of the components driving the determination of a marketability discount is a quantifiable risk associated with purchasing a restricted stock."

But empirical studies that primarily examine discounts in the context of comparable earnings and revenues may ignore factors such as block-size, holding period, number of weeks to sell, and trading volume. Much of the data are aged, and any reliance on published averages in the studies without accounting for the underlying data points, "channels" the analysis to yield an average result rather than a wide range.

Moreover, in his reliance on just two studies, the expert for the corporate taxpayers did not take into account the "severe" restrictions imposed on HRN stock, which-unlike the stock in the studies-could not be easily "collared" or sold in private placement. He also did not factor the effect of a block sale by the former owners, which would likely depress the market. "Thus [his] opinions that everything evens out and the appropriate [marketability discount] is 20% are

incongruent in the factual context."

The IRS criticized the taxpayers' use of the Black-Scholes model for being "one-sided," insuring against only the downside risk, whereas its "option collar" accounted for not only the cost of a put but also a call option. While the theoretical approach had some merit, the Court found that "the size of the HRN restricted stock, as compared to the public float, renders such a transaction impossible as a practical matter."

Moreover, in an internal memorandum discussing the taxpayers' audit, the IRS valuation agent used an option-discount methodology. This was "the most persuasive real world factor" supporting the taxpayer's methodology," the Court said, finding the option-pricing model an "accepted method within the appraisal community of valuing restricted shares." The model effectively valued marketability or "the right to sell," which is one of the more valuable rights available to the holder of securities.

The Court generally approved of the quantitative approaches used by the individual taxpayers' expert, with adjustment to account for items the parties specifically negotiated in their purchase agreement, such as the early lifting of restrictions. The Court subtracted 25% from the lower range of the taxpayers' marketability discounts, concluding a range from 22% to 50% in years one through four. Applying these discounts, it reached a final fair market value for the stock of \$12.48 in year one, \$10.24 in year two, \$9.92 in year three, and \$8.00 in year four.

Five Factors Test for Reasonable Compensation

Vitamin Village, Inc. v. Comm'r, 2007 Tax Court Memo Lexis 278 (September 12, 2007)

In *Exacto Spring Corp. v. Commissioner* (1999), *Exacto* cited the Ninth Circuit decision in *Elliotts, Inc. v. Commissioner* (1983) as its support to determine reasonable compensation under Internal Revenue Code (IRC) section 162(a)(1). *Elliotts* applied five factors to determine reasonable compensation under section 162(a)(1), one of which (conflict of interest) frames the inquiry from the perspective of an independent, inactive investor. *Elliotts* remains the leading authority in the Ninth Circuit and guided the Tax Court's inquiry in this case.

Daniel Reeves started Vitamin Village ("VV") in 1979 to produce and sell nutritional supplements and related health food and sports performance products; the company also provided indoor tanning and printing/marketing services. Over the years, Reeves, the sole shareholder, served many roles working more than eighty hours a week. In 1994, the tanning and advertising services were spun into two

separate corporation; Reeves maintained executive control and ownership of both. He also maintained his primary responsibilities at VV.

The company did not maintain a formal compensation policy, but internal memoranda consistently noted that Reeves had received less than full and adequate compensation during the early years and would be considered for a salary increase in the future. Beginning in 1993, business improved substantially. In fiscal years 1995 and 1996, the company paid Reeves \$2.278 million (including a \$2 million bonus) and \$1.012 million (\$1 million bonus), respectively.

The IRS determined that only \$1 million of compensation in 1995 and \$0.75 million in 1996 were reasonable and deductible. At trial, the IRS' accredited financial analyst compared Reeves' compensation to that of CEOs in five publicly traded comparable companies. His conclusion: \$1,010,678 was reasonable pay in 1995, and \$750,936 in 1996.

Subsequently, the IRS expert conceded that a few of the selected comparables suffered significant losses in 1995 and 1996, which may have led them to cut executive compensation, thus understating their value in the analysis. Due to the limitations of his review, the IRS expert was unable to account for all relevant facts and circumstances.

The Court noted these points in its five-factor Elliotts analysis:

1. Role in the company - Reeves' work and vision were critical to the business. He remained "highly motivated" and a "driving force" behind the business' ultimate success.

2. External comparison - The IRS expert admitted that an employee (like Reeves) who served several positions within the same company could receive higher compensation as a result. Further, a company that underpays an employee in low-income years will often make up the shortfall in more profitable years, including reimbursement for the time value of money. Executives presiding over highly profitable years may also be entitled to increased compensation. Finally, because public companies have up to 5% more costs than private companies, they may have less income available as compensation.

3. Character and condition of the company - This focuses on the company's size (sales, net income, or capital value), its complexity, and general economic conditions. In this case, the company was small but had secured a relatively profitable niche; its gross sales increased substantially after 1993, and its return on equity reached 93% in 1995 and 25% in 1996. The company's operation was no "simple task" for Reeves, especially given the success he helped it achieved.

4. Conflict of interest - Heightened scrutiny

is required when corporate officers set their own compensation, especially when coupled with absence of dividends. Elliotts looks to a hypothetical investor's returns on equity (ROE): If a company's earnings after payment of compensation meets an average of 20% ROE, "there is a strong indication that the employee is providing compensable services, and that profits are not being siphoned out of the company disguised as salary." In this case, the 93% and 25% ROE "substantially exceeded" the guideline companies' average ROEs of 5.9% and -54.4% during the same years.

5. Internal consistency - The company had no "structured, formal, and consistently applied" compensation program. But it made formal provision to reimburse Reeves in the future for the sacrifices he made during the "lean" years.

Under these facts, and including adjustments for errors and underpayments, the Court found that reasonable compensation totaled \$2 million in 1995 and \$1.012 million in 1996.

SEC Accelerates Approval of Amended Rule 2290

The Securities and Exchange Commission recently published its approval of amended Rule 2290 in the Federal Register (October 17, 2007). Originally proposed by the National Association of Securities Dealers (NASD), which has since been reorganized as the Financial Industry Regulatory Authority (FINRA), the new Rule 2290 addresses disclosures and procedures related to the issuance of "independent" fairness opinions.

"The Commission believes that [the amended rule] clarifies the obligations of FINRA member firms," the SEC says, "and believes that approving [the amended rule] will provide greater clarity and simplify compliance, thus furthering the public interest and the investor protection goals of the Exchange Act." Further, "the Commission finds that it is in the public interest to approve the proposed rule change as soon as possible to expedite its implementation... on an accelerated basis." The proposal was open to public comment for thirty days and became final on the November 21, 2007.

The approval and implementation of the new rule could mean that the days of one- and two-page fairness opinions are ending. Management projections will now require independent verification, and compensation packages that were negotiated as part of the transaction will now have to be disclosed. Careful documentation of the deal, from inception to closing, will be essential. A copy of the new Rule 2290

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(as published in the Fed. Reg.) and all related postings are available at <http://www.finra.org/RulesRegulation/RuleFilings/2005RuleFilings/p014559>.

IRS Extends 409A Compliance Deadline to Next Year

The Treasury Department and the Internal Revenue Service (IRS) recently announced that taxpayers will have until December 31, 2008, to bring documents into compliance with the final nonqualified deferred compensation regulations under section 409A of the Internal Revenue Code. Last April, the Treasury and IRS issued final 409A regulations, which provide guidance regarding the requirements for deferral elections and payment timing under section 409A. Affected plans and arrangements were originally required to comply with the final regulations by December 31, 2007.

IRS Notice 2007-78 extends the document compliance deadline for one year and provides additional limited transition relief. Importantly, the Notice does not postpone the effective date of the final regulations, which were already extended once, from January 1, 2007, to January 1, 2008. The Treasury and the IRS anticipate issuing further guidance "containing a limited voluntary compliance program that will permit

taxpayers to correct certain unintentional operational violations of 409A and thereby limit the amount of additional taxes due under 409A," although the Notice does not indicate when to expect the additional guidance. A copy of the Notice is posted at www.irs.gov/pub/irs-drop/n-07-78.pdf.

Unique Business Opportunity: Harley-Davidson Dealership For Sale

Value Management Inc. is serving as the intermediary in the sale of a mid-size (@ 275 - 300 bikes annually) Harley-Davidson Dealership (the "Dealership") located in New Jersey. The Dealership moved to its current location in 2001; it has a modern facility comprising approximately 24,000 sq. ft. situated on over 5 acres. The Dealership sells a full line of new and used Harley-Davidson motorcycles, MotorClothes® apparel, collectibles, and Genuine Motor Parts & Accessories. The growing Dealership also services motorcycles in its state-of-the-art, 6 bay/12 lift service center. Please contact Andrew Wilusz, Director of Mergers & Acquisitions, for additional information. Andrew can be reached at: amw@valuemanagementinc.com or at 215-598-9310.

If you would like to receive a copy of any of the aforementioned court cases or to discuss a particular business valuation issue, please feel free to contact Susan Wilusz, at (215) 598-9310 or smw@valuemanagementinc.com.

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