

Valuation Vantage[®]

Spring-Summer 2013

Insights and perspectives on leading corporate finance valuation issues.

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IRS and the Courts Go After 409A Valuation Issues

In late 2004, President Bush signed the American Jobs Creation Act, a set of laws that made broad changes to the design and operation of nonqualified deferred compensation plans. These laws included section 409A, which set specific requirements for deferred compensation plans. Section 409A defines nonqualified deferred compensation as, “any plan that provides for the deferral of compensation, other than a qualified employer plan, vacation leave, sick leave, compensatory time, disability pay, or death benefit.” Deferred compensation plans that fail to meet these specific requirements are subject to immediate taxation in the current year, prior year deferrals and earnings, and a 20% penalty with interest for underpayment of taxes.

continued

“IRS and the Courts Go After 409A Valuation Issues” continued

During the past year, the IRS has scrutinized discounted stock options. In a recent case, *Sutardja v. United States*, no. 11-725T (Fed. Cl. Feb. 27, 2013), a federal claims court ruled that section 409A allows for taxation of discounted stock options.

Background

Plaintiffs, Dr. Sutardja and his wife, Mrs. Dai, obtained stock options as compensation from their employment at Marvell Semiconductor, Inc. (“MSI”). On December 26, 2003, MSI’s Executive Compensation Committee granted Dr. Sutardja 1.5 million common options, which were exercisable only while Dr. Sutardja remained employed by MSI or within 30 days of termination. At the time they were granted, the options, governed by California law, did not have a discernible Fair Market Value. In 2006, the Plaintiffs exercised their options, reported their income from the exercise, and paid their estimated federal tax payments. However, in late 2010, the Plaintiffs received an IRS Notice of Deficiency demanding a late-filing penalty, additional taxes and an interest payment on the late taxes.

The Plaintiffs’ Position

The Plaintiffs argue they are entitled to a tax refund for all 409A related taxes paid for four reasons:

- 1) The grant of an employee stock option is not a taxable event;
- 2) Treasury regulation 3121(v)(2) excludes stock options from treatment as deferred compensation;
- 3) Plaintiffs did not have a “legally binding right” to the shares until the exercise of the options, and
- 4) Any deferral of compensation attributable to the options was exempt from section 409A taxation under the short-term deferral exception set forth in IRS notice 2005-1, 2005-1 C.B. 274.

The Court’s Conclusion

The US Federal Claims Court found that IRS Notice 2005-1, which offered transitional guidance pertaining to the types of deferred revenue covered by section 409A, defined a grant of a discounted stock option as a taxable event. Additionally, in a preamble to section 409A, dated October 4, 2005, the IRS explicitly cross-referenced the regulations set forth in Section 3121(v)(2) and found these regulations not applicable to 409A.

The court further ruled, from precedents set by Commissioner v. Smith and Commissioner v. LoBue, that discounted stock options are to be treated as compensation when granted as opposed to when the options are exercised.

Lastly, the Plaintiffs argued that the options were subject to substantial risk due to the necessity of Dr. Sutardja’s employment to exercise. However, the court viewed the 30-day limitation period of the stock options to be a grace period for the Plaintiffs to exercise their options which therefore posed no substantial risk. Since the court dismissed each of the Plaintiff’s claims, the next step will be to determine whether the stock options were granted at a discount to Fair Market Value.

Best Practices

This issue arose between the IRS and the plaintiffs over suspicion that the stock options were granted at a discount. To prevent potential IRS issues, it is recommended that companies expecting to issue options complete a business valuation and then set a strike price at or above the Fair Market Value to minimize the risk of a 409A investigation. ♦

Is the Book Value of Your Debt Really All that Fair?

Business combinations and the resulting purchase price allocations call not only for the target company's acquired tangible and intangible assets to be reported at their fair values on the opening balance sheet, but for interest-bearing debt liabilities to be fair valued as well. The consideration of the fair value of debt also is required when reconciling from enterprise value to equity value in some circumstances.

Analyzing Fair Value

In many cases, the interest-bearing debt liabilities' fair value is consistent with its book value on the balance sheet. However, in some instances the book value of a company's debt may not truly be representative of its fair value.

Assessing a debt instrument's underlying interest rate and comparing it to current levels based on prevailing debt market conditions may shed light on key differences between the two.

When the debt has a floating interest rate that is adjusted regularly in accordance with LIBOR, for example, the liability's corresponding interest is in line with market levels and no adjustment would be necessary. However, in the case of fixed rate debt instruments where a significant period of time has elapsed since issuance or if the debtor's credit risk has changed drastically, initial fixed rates may no longer be consistent with market rates for comparable companies with similar risk profiles.

It then may be necessary to evaluate the credit ratings for comparable companies while also holding discussions with management to determine what rates they would expect the company to incur if debt financing were sought as of the valuation date. Once an interest rate is selected, it can be applied in a present value calculation that discounts expected coupon and principal payments back to the acquisition or valuation date being applied in the analysis.

Best Practices

Accounting standards require companies to record debt at fair value. The AICPA's *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* advises that, "For the purpose of valuing minority interests in the equity securities of an enterprise, a valuation specialist would need to estimate the fair value of equity. Thus if the specialist begins by estimating the total enterprise value, the specialist would then subtract the fair value of debt, if any, from the total enterprise value." Therefore, it is necessary for the specialist to assess outstanding debt instruments when performing a fair value analysis for purchase price allocation, impairment testing and share based compensation purposes, as the book value of such debt may not be representative of its fair value. ♦

FASB Clarifies Nonpublic Entity Fair Value Disclosures

Effective February 7, 2013, The Financial Accounting Standards Board (FASB) amended its Accounting Standard Update (ASU) 2011-04, *Fair Value Measurement (ASC 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, with the issuance of ASU 2013-03 *Financial Instruments (ASC 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities*.

After ASU 2011-04 was issued in May 2011, stakeholders became concerned by potential conflicts between ASC 820 and ASC 825 requirements. After some deliberation, FASB determined that fair value disclosures should not be required in certain cases involving nonpublic entity financial statements.

Clarifying ASC 825

ASU 2013-03 was issued to resolve confusion regarding which private companies and nonpublic, not-for-profit organizations should be excluded from the requirement to disclose fair value hierarchy levels 1, 2 or 3.

The fair value hierarchy classifies fair value measurements into the following three classes:

- Level 1 Inputs are quoted prices in active markets for identical assets or liabilities.

- Level 2 Inputs include quoted prices for similar assets or liabilities in active markets.
- Level 3 Inputs are unobservable and are developed based upon the best information available under the circumstances, which might include a company's own data; such inputs should reflect assumptions based on the perspective of an active market participant. This level is intended for situations involving little or no market activity for the asset or liability as of the measurement date.

With the issuance of ASU 2013-03, some nonpublic companies are not required to disclose the fair value hierarchy level for its fair value estimates.

“FASB Clarifies Nonpublic Entity Fair Value Disclosures” continued

As a result of ASU 2013-03, the updated ASC 825 now reads as follows:

825-10-50-3 Except as noted in the following paragraph, for annual reporting periods, the disclosure guidance related to fair value of financial instruments in paragraphs 825-10-50-10 through 50-19 applies to all entities but is optional for an entity that meets all of the following criteria:

- a. The entity is a nonpublic entity.*
- b. The entity’s total assets are less than \$100 million on the date of the financial statements.*
- c. The entity has no derivative instrument under Topic 815 other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.*

825-10-50-3A A nonpublic entity is not required to provide the disclosure in paragraph 825-10-50-10(d) for items disclosed at fair value but not measured at fair value in the statement of financial position.

Best Practices

With the issuance of ASU 2013-03, some nonpublic companies are not required to disclose the fair value hierarchy level for its fair value estimates. However, performing fair value analysis and the disclosure of fair values for applicable balance sheet items in the notes to the financial statements remains a necessary practice for annual reporting purposes. Additionally, disclosure guidance for public companies and non-exempt, nonpublic companies has not been affected; these entities must continue to disclose the hierarchy level of its fair value measurements. ♦

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The McLean Group

The McLean Group provides M&A, business valuation and strategic consulting services to middle market businesses. Headquartered in Washington, DC, we are among the largest independent middle market investment banks in the nation with a broad resume of successfully consummated financial transactions.

Practice Highlights



On June 7, 2013, The McLean Group spoke on an executive panel, *The Short and Long Term Future of M&A in the Food & Beverage Industry*, at the Healthy Beverage and World Tea Expos in Las Vegas, NV. This panel provided attendees with an understanding of M&A trends fueling the healthy drink segment of the beverage market and helped buyers and sellers alike evaluate acquisition opportunities to capitalize on this fast-growing segment.



On May 31, 2013, the Valuation Roundtable of San Francisco hosted its 27th Annual Seminar at The Olympic Club, Lakeside Clubhouse in San Francisco, CA. The program included three sessions: Current Issues in Estimating Cost of Capital; Liquidity and Size Premiums, and an Economic Outlook. Brian Sullivan, Managing Director of The McLean Group, Silicon Valley, is the current president of The Valuation Roundtable, which furthers the business valuation profession by sharing information and opinions regarding methodology and empirical research among accredited and experienced valuation professionals.



The Middle Market Investment Bankers' Association's (MMIBA) Annual Conference took place on June 7, 2013 in Washington, DC. MMIBA provides training, research and certifications on M&A and valuation issues for its members. The McLean Group is an MMIBA sponsor. Learn more about MMIBA [here](#).

The McLean Valuation Services Group

As a core competency and complement to our M&A practice, The McLean Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes. The McLean Valuation Services Group has the requisite experience and credentials to support litigation proceedings, including quantifying economic damages and valuing business interests.