ADVISORY SERVICES: VALUATION

IRS Section (§) 409A: Valuation Implications

IRS Section (§) 409A was enacted under the Jobs Creation Act of 2004. It applies to nonqualified deferred compensation, amounts employees earn in one year which will not be paid until a future year. Deferred compensation includes options and stock appreciation rights (SARs), as well as many other arrangements with employees, unless the options or SARs meet strict regulatory guidelines to avoid the application of §409A.

Many start-up companies issue stock options or SARs to their key personnel to preserve cash needed for the business and as a mechanism to incentivize these key individuals. Business owners sometimes are not aware of the requirements under §409A or do not want to pay for the valuation. In certain cases, not completing a valuation can have severe consequences.

Non-qualified stock options are generally taxable to the holder at the date of their exercise, not at the date of grant or vesting. SARs are generally taxed on the settlement date. §409A preserves this tax treatment, but only if the stock option or SAR is granted with an exercise price which is at or above the fair market value of the underlying stock on the date of the grant. While the fair market value of a publicly traded stock on the grant date is easy to determine, private company stock will need to be valued using a reasonable application of a reasonable valuation method. A taxpayer is deemed to satisfy this test with an independent valuation as of a date within the last 12 months of the date the option or SAR is granted.

A §409A valuation is performed by applying the valuation methods used to determine fair market value for other forms of equity-based compensation. At Cherry Bekaert, our Valuation Services group consists of seasoned finance and valuation experts with ASA, ABV, CBA, CVA or CFA professional credentials.

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Based on the guidance, companies may respond to the regulations in one of the following ways:

Maintain Status Quo

Retain existing option pricing practice if exercise prices are believed to exceed fair market value. Upon an IRS audit, if exercise prices are found to be lower than fair market value, the burden will fall on the company to prove that its stock valuation method was reasonable and reasonably applied. If it fails to meet this burden, §409A and the related adverse tax consequences will apply for all years from the date of grant until the present.

Informed Valuations Based on Specified Factors

The regulations provide that companies less than 10 years old (including predecessor operations) can perform an internal stock valuation based on specified factors (e.g., values of tangible and intangible assets, present value of future cash flows, comparable company transactions, etc.). This needs to be documented in a written report prepared by an individual with the knowledge and expertise to value equity. By meeting these rules, the burden of proof for determining value is shifted to the IRS.

Independent Appraisal

Rely on a professional appraiser's report (e.g., third-party valuation), which the regulations allow to establish the fair market value presumptively by qualified independent valuation experts using recognized valuation methods. This shifts the burden on the IRS to prove the valuation is unreasonable.

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