MERCER CAPITAL

# VALUE MATTERS™

The Complimentary Electronic Newsletter for Attorneys and Other Professional Advisors to Business

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## Recently Gone or Going Public?

### Watch Out for IRC Section 409A

*If you have an equity-based compensation plan, the stakes are higher than ever to make sure that you are valuing the compensation properly. Failure to do so can lead to excise taxes and penalties that can only be described as confiscatory. Executives in charge of maintaining equity-based compensation plans should seek advice from a qualified tax professional regarding the plan's compliance with IRC Section 409A. Furthermore, any issuer of deferred equity-based compensation should employ the services of an independent valuation expert in order to assure that the plan is not granting deferred compensation at a discount.*

The 2004 passage of the American Jobs Creation Act brought with it the addition of Section 409A to the Internal Revenue Code. Section 409A carries potentially burdensome tax implications for individuals rewarded under non-qualified deferred compensation plans. Individuals charged with the responsibility of maintaining a plan of this type must take care to structure company plans in such a way as to abide by the stringent regulations of Section 409A. Otherwise, employees could face unexpected taxes, penalties, and interest on deferred compensation.

The IRS issued Notice 2005-1 in December 2004 in an attempt to provide guidance in the application of Section 409A. In September 2005, further guidance was issued in the form of proposed regulations on deferred compensation. While the latter material should be viewed as guideline in nature, it is widely assumed that the reliance upon these regulations by plan administrators and tax professionals will evidence good-faith compliance with Section 409A.

Notice 2005-1 attempts to curtail perceived frustration with Section 409A by elaborating on a few key topics mentioned in Section 409A. Most notably, explanations are made to clarify definitions of deferred compensation and non-qualified deferred compensation plans, and the federal income tax consequences of violations of Section 409A are clearly set forth. The preceding points are discussed in the following sections.

**What Qualifies as a Deferral of Compensation?**

The plan mandates that compensation must be recognized as deferred (and income taxes must be paid on any such deferred income as if it were ordinary income) if "the service provider has a legally binding right during a taxable year to compensation that has not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year." However, if this legally binding compensation may be unilaterally reduced or eliminated and if this reduction or elimination is likely to occur, the participant is relieved from his obligation of reporting this deferred income and paying associated taxes until such income is realized.

Notice 2005-1 goes on to describe the various categories of deferred compensation. While it is not necessary for our purposes to enumerate each type, the category labeled as stock options, stock appreciation rights, and other equity-based compensation is worthy of discussion. Elaboration on the restrictions and the implications of these restrictions related to equity-based compensation can be found later in this article.

**What Constitutes a non-qualified Deferred Compensation Plan Under Section 409A?**

A non-qualified deferred compensation plan means any agreement (written or verbal) that provides for the deferral of compensation. An agreement with just one individual can still qualify as a non-qualified deferred compensation plan, and these plans are not limited to arrangements between employers and employees. That is, Section 409A may apply to an agreement between a service recipient and an independent contractor as well as an agreement between a partner and a partnership. *As noted above, this definition specifically includes **discount** stock options and **discount** stock appreciation rights. However, any equity-based compensation not issued at a discount, does not apply to Section 409A.*

**What Federal Income Tax Consequences Are Associated with a Violation of Section 409A?**

If a non-qualified deferred compensation plan fails to adhere to the provisions set forth in Section 409A, tax penalties for the participant will be incurred. That is, all amounts deferred under the plan for the taxable year (and all prior taxable years) must be included in gross income for the taxable year to the extent that such income is contractual and not highly unlikely to occur. *If a deferred amount is required to be included as income under Section 409A, then the participant must pay interest as well as an income tax penalty in addition to ordinary income taxes. The additional income tax penalty is equal to 20% of the compensation required to be included in gross income.* The option or SARs holder would be taxable on the increase in value of the option at the time of vesting (regardless of whether the option is exercised at this point), and the holder would be required to pay an additional 20% penalty and interest on underpayment.

**Discount Options and Stock Appreciation Rights Result in Negative Tax Consequences**

Non-qualified stock option grants will be subject to deferred compensation taxation unless the plan provides that:

1. The exercise price may never be less than the fair market value of the underlying stock on the date of grant;
2. The receipt, transfer, or exercise of the option is subject to taxation under Section 83 provisions; and,
3. The option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise date or settlement of the option.

Stock Appreciation Rights (SARs) will be subject to deferred compensation taxation unless the plan provides that:

1. The SAR exercise price may never be less than the fair market value of the underlying stock on the date the right is granted;
2. The stock of the service recipient is traded on established securities markets;
3. Only such traded stock of the service recipient may be delivered in settlement of the right at exercise; and,
4. The SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the right.

Notably, Notice 2005-1 indicates that for a non-qualified deferred compensation plan to be exempt from Section 409A, the stock of any plan issuing SARs must be traded on an established securities market (see number 2, above). The revised provisions, issued later, exempted SARs of private companies from Section 409A if the SARs were issued at fair market value without any discount or features for deferral.

**In Summary**

Notice 2005-1 and the proposed regulations taken together indicate that options and SARs issued at or above fair market value as determined by a "*reasonable application of a reasonable valuation method*" will be exempted from deferred compensation taxation under Section 409A. Notice 2005-1 indicates that a reasonable valuation method would include the valuation method described in Section 20.2031-2 of the Estate Tax Regulations. The revised provisions take this a step further by stating an appraisal will be acceptable for purposes of Section 409A if the appraisal would be acceptable for valuing stock held in an ESOP under the provisions of the Internal Revenue Code. Any such suitable appraisal will be acceptable for a twelve month period beginning on the valuation date.

At Mercer Capital, we have considerable experience in valuing companies that are in the process of going public and have provided valuations for compliance with Section 409A. If you have any questions or need our assistance with a matter such as this, don't hesitate to call us at 901.685.2120.

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## COMING SOON

## Buy - Sell Agreements: The Do's and Don'ts

*A New Book from Mercer Capital*

*Coming June 2006*

Mercer Capital has reviewed hundreds of buy-sell and other shareholder agreements, and we want to share our "lessons learned" with you. We do not offer legal opinions or guidance, but instead provide a list of things to watch out for and why they are important. Written for business owners, attorneys, CPAs, insurance providers, as well as other business appraisers, the book powerfully illustrates the valuation consequences of badly-drafted agreements.

To be notified of the publication date and qualify for the special pre-publication discount, email Barbara Price at priceb@mercercapital.com. Please type "Buy - Sell" in the subject line, and be sure to provide your name and address in the message.

## ANNOUNCING MERCER CAPITAL'S E-BOOK LIBRARY

| Title | Description | Investment | Release Date |
|---|---|---|---|
| **Valuing Shareholder Cash Flows: Quantifying Marketability Discounts** | *Quantifying Marketability Discounts* has been updated and is now offered as an e-book. Titled *Verifying Shareholder Cash Flows: Quantifying Marketability Discounts - 2005 E-Book,* this edition provides a brand new chapter which discusses each of the five assumptions of the QMDM in depth. As a bonus, when you purchase the e-book, you will also receive the *QMDM Companion,* the latest edition of the Quantitative Marketability Discount Model in spreadsheet format. We plan to continually add content to this e-book, and as a purchaser, you will receive this content free-of-charge when it becomes available. | **$95.00** | *Currently Available* |
| **Valuing Financial Institutions** | We are responding to requests to put this book back into print and we are doing so as an e-book | **$65.00** | *Currently Available* |
| **Valuation for Impairment Testing** | The first SFAS 142 valuation resource for CFOs and auditors. Also available in printed form at www.mercercapital.com | **$45.00** | *Currently Available* |
| **Are S Corporations Worth More Than C Corporations?** | An e-booklet that adds to the S Corp vs. C Corp. debate | **Complimentary** | *Currently Available* |
| **Embedded Capital Gains** | An examination of the Embedded Capital Gains issue through 2005 | **$19.95** | *Currently Available* |
| **Rate & Flow: An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions** | In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution. In states where an owner/spouse's active management of a business does not preclude the consideration of passive appreciation we offer a fresh approach based on rate and flow analysis | **Complimentary** | *Currently Available* |

**Visit our website at www.mercercapital.com for more information or to download an e-book.**

## MERCER CAPITAL ON THE ROAD

**February 20, 2006**
"Buy - Sell Agreements: The Do's and Don'ts
From A Business Appraiser's Perspective"
Firmwide Presentation: Butler Snow Law Firm
Memphis, Tennessee
**Z. Christopher Mercer, ASA, CFA**

**March 7, 2006**
"Marketing Best Practices"
Teleseminar sponsored by IGAF
**Matthew G. Washburn &**
**Barbara Walters Price**

**March 9, 2006**
"Marketing Your Business Valuation Practice"
Teleseminar sponsored by BV Resources
**Barbara Walters Price, Moderator,**
**Z. Christopher Mercer, ASA, CFA, Panelist**

**May 2, 2006**
Philadelphia Estate Planning Council Annual Seminar
Philadelphia, Pennsylvania
**Z. Christopher Mercer, ASA, CFA**

**May 3, 2006**
Mississippi Financial Planning Conference
Jackson, Mississippi
**Timothy R. Lee, ASA**

**June 1, 2006**
"Buy - Sell Agreements: Reasonable Resolution or
Ticking Time-Bomb"
NACVA's Annual Conference
San Francisco, California
**Z. Christopher Mercer, ASA, CFA**

**October 19-20, 2006**
"Today's Word on Lack of Marketability"
CICBV/ASA Annual Conference
Toronto, Canada
**Z. Christopher Mercer, ASA, CFA**

The professionals of Mercer Capital have a great deal of experience speaking to industry and professional groups across the nation on topics such as:

- Buy-Sell Agreements
- The Integrated Theory of Business Valuation
- Is Your Business Ready for Sale?™
- Purchase Price Allocation
- Valuation of Employee Stock Options
- Litigation Support and Expert Testimony
- Valuation of Privately Held Businesses, Partnerships, or LLCs
- Financial Institution Valuation
- ESOP Valuation

**To book a Mercer Capital professional as a speaker at your next conference or CLE/CPE meeting, please contact Barbara Walters Price at priceb@mercercapital.com.**

## A GENTLE PLUG FOR OUR FIRM

**MERCER CAPITAL** is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

**CORPORATE VALUATION.** Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- Dispute Analysis Services and Expert Testimony
- Valuation for Corporate Tax Matters
- Valuation for Corporate Income Tax Issues
- Valuation for ESOPs
- Purchase Price Allocations
- Valuation of Employee Options
- Goodwill Impairment Testing
- Valuation of Intangible Assets
- Fairness Opinions

**INVESTMENT BANKING.** Mercer Capital's investment banking division and specializes in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

## INTERNET COMMERCE: OBTAIN PROPOSALS TO VALUE YOUR COMPANY, BANK, FLP OR LLC VIA OUR WEBSITE

The cost of your time and delays in obtaining proposals has just gone down. Use one of the PROPOSAL REQUEST FORMS on our website.

Many of your colleagues have already used our PROPOSAL REQUEST FORMS and are impressed by the decrease in transactional overhead and the increased ease in obtaining actionable proposals for their clients. We are pleased to be doing business with them. Try it yourself! Visit our website and provide us with the pertinent information via this form, and we'll prepare a proposal and deliver it to you via e-mail, fax or USPS. Complete confidentiality is assured.

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We will continue to send the newsletter as published at no cost unless you notify us that you wish to be removed from the distribution list. To REMOVE yourself from this list, send an e-mail to: mercer-owner@mercercapital.com and type the words "Unsubscribe – Value Matters" in the subject line (without the quotation marks).

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It is time to take control
of your future.
Do not let another day pass
without paying attention
to your most important asset -
your business .

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# Is Your Business Ready For Sale?

TELESEMINAR SERIES

## NOW AVAILABLE ON CD

The focus is on value - understanding, building, and realizing the value of and in your business. This is NOT a come-on to try to convince you to sell your business now. This IS an unabashed effort to convince you to begin the process of getting your business ready for sale - so that when you are ready - or when an unexpected offer comes along - you and your company are ready.

Business owners and professional advisors should listen to this teleseminar. Chris Mercer has taken knowledge learned from working with hundreds of business owners and encapsulated it to a few hard truths about value and what you must be focused on every day.

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# Is Your Business Ready For Sale?

TELESEMINAR SERIES

**SESSION ONE: A CALL TO ACTION**

Session One is a call to action. After listening to this session, business owners interested in selling their business now or in the future, as well as their professional advisors, will understand:

- Why the topic, Is Your Business Ready for Sale?™, is so important today
- Your business will sell, one way or another, and why you should plan for that transaction
- Your business is an investment and should be thought of as an investment, not a paycheck
- The dynamics of business value and growth
- The financial, operational and leadership characteristics of a business that is ready for sale

And, for those business owners who are buyers of businesses, we ask the question: "Is this business ready to buy?"

**SESSION TWO: FOCUS ON "READY"**

This session is packed full of information that is actionable and applicable to running your business every day in a manner that increases its value to a potential buyer. The listener was treated to several "take-aways" or bits of information that no one else is telling you that you can use to enhance the value of your business. The session contained the following information:

- Who picked 65 as the mandatory "retirement" age anyhow?
- Why is succession planning so hard for so many business owners?
- How many businesses will transact in the next ten years or so?
- What risk is so important to focus on yet so often ignored?
- Why do private equity groups buy some businesses and not others?
- What one simple thing can you do today to increase your earnings and your margins?
- Why should the business owner be wary of "recasting" earnings?
- What do you do when an unexpected offer for your business arrives?
- What was the life-changing advice of Wally Lowenbaum and how can it make a difference in your business?
- How do you assess the strengths and weaknesses of your business today to enhance its value to an outside buyer?

**SESSION THREE: PATHWAYS TO LIQUIDITY**

In this session, we will reveal your "Pathways to Liquidity," or an overview of the markets for privately held businesses. We'll answer the questions:

- What alternatives for liquidity exist for most businesses?
- Who are the buyers for businesses of various sizes?
- What are they looking for, particularly in the context of "Is Your Business Ready for Sale?"
- Why are private equity groups so important to you?
- Why do "multiples paid" tend to congregate in certain ranges for certain industries?

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