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THE COMPLIMENTARY NEWSLETTER FOR ATTORNEYS AND OTHER PROFESSIONAL ADVISORS TO BUSINESSES

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The Clock is Ticking for Section 409A Compliance

The deadline for compliance with IRC Section 409A is fast approaching. Section 409A generally became effective in January 2005; however, the IRS recently extended the effective date of the final regulations until January 1, 2008 for most companies. As the new deadline approaches, the IRS is issuing continuing guidance with respect to employee tax reporting, withholding, and transition relief. But the critical point remains: bring your nonqualified deferred compensation plan into compliance with Section 409A by the deadline or be prepared for an onslaught of penalties and taxes to you and your employees.

409A Recap

Added to the tax code as part of the American Jobs Creation Act of 2004, Section 409A generally requires that amounts deferred under a nonqualified deferred compensation plan (including stock options and stock appreciation rights or "SARs") for all taxable years are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture and not previously included in gross income. With respect to stock options, the IRS concern is that stock options and SARs issued "in the money" are really just a form of deferred compensation, representing a shift of current compensation to a future taxable year. In order to avoid being subject to Section 409A, employers need to demonstrate that all stock options and SARs are issued "at the money" (strike price equal to the FMV of the underlying shares at the grant date).

Stock options that were granted or that vest on or after January 1, 2005, and that have an exercise price that is less than the fair market value of the company's stock on the date of grant are subject to Section 409A (referred to as Discounted Options). If the Discounted

Options are not corrected by either fixing the payment terms or increasing the exercise price to fair market value as of the date of grant, such options will violate Section 409A and be subject to a 20% penalty tax and interest in addition to regular income and employment taxes.

So what's new?

The original proposed regulations of Section 409A were expected to become effective January 1, 2007. But in October of 2006, the IRS issued Notice 2006-79, which extended the compliance deadline to December 31, 2007 for most companies. Companies that have had problems with backdated options or may have to restate financial statements in the future as a result of backdated options were not given the one year extension for compliance. For these companies, the deadline remains December 31, 2006.

But that's not all. In November 2006, the IRS issued guidance to the effect that under Section 409A, all existing discounted options (even those that are unexercised) are subject to current income tax withholding and reporting for employees holding the options. The withholding and reporting pertains to deferred amounts that have now become includible in income in 2005 or 2006. This means that an employer must start withholding money from an employee's wages for payroll taxes based upon the "deferred amount." For stock options and SARs, the amount includible in income is equal to the fair market value of the underlying stock less (1) the exercise price, less (2) any amount paid for the option, less (3) any amount previously included in income with respect to the right.

One would not expect Average Joe Employee to be pleased to learn that he (and not his employer) is suddenly responsible for paying income taxes and penalty taxes on "discounted" stock options he has not yet exercised! The options may not even be in the money at the time the taxes and penalty are due. While there is no cure-all remedy, there are a few possible solutions to the problem. The Company could reprice the options to set the exercise price to the fair market value at the grant date. While this solves the issue of 409A compliance for the option itself, it does nothing to comfort Average Joe Employee whose options will decline in value as a result of a higher strike price. Companies may choose to offer cash bonuses to employees to offset the loss in option value, although it is important to note that such payments would be considered additional, and taxable, ordinary income. A similar situation might exist for employees who exercised discounted options in 2006 and now face 409A penalty taxes.

For companies that still have until the end of 2007 to bring their plans into compliance with Section 409A, the extra time should be seen as an opportunity to get things right ASAP. If compliance is achieved before the final regulations become effective, the withholding and reporting requirements as well as the 409A penalty taxes could potentially be avoided.

409A RESOURCES

Not All Classes of Equity Were Created Equal: Focus on Section 409a
9/21/06 » B. Patrick Lynch

IRS Code Section 409a and Valuation
8/28/06 » Z. Christopher Mercer

Eight Things You Should Know About Section 409a
6/08/06 » Travis W. Harms

Watch Out for Section 409a
2/16/06 » Eden A. Gipson

How to ensure compliance?

Generally, a nonqualified deferred compensation plan adopted on or before December 31, 2007 will not be treated as violating Section 409A if (1) the plan is operated through December 31, 2007 in reasonable, good faith compliance with the provisions of Section 409A and other applicable provisions and guidance and (2) the plan is amended on or before December 31, 2007, to conform to the provisions of 409A and the final regulations.

For both public and private companies, it is crucial that the exercise price not be less than the fair market value of the underlying stock at the grant date for stock options that may fall under the net of Section 409A. If you currently have a stock option plan or other deferred compensation plan in place, then the clock is ticking to make sure that your plan is Section 409A compliant. If the plan does not conform to Section 409A by the deadline, there could be significant adverse tax consequences to both employer and employee related to the 2005 and 2006 tax years.

For companies that are considering the implementation of a nonqualified deferred compensation plan before the end of the year, the most obvious course of action is also the correct one - obtain an independent appraisal of the fair market value of the company's stock as of the grant date. By establishing a sound and reasonable valuation of the stock on the front end of the process, the potential headaches of Section 409A can be substantially reduced and possibly even eliminated. Mercer Capital has the experience and knowledge necessary to provide you with a reasonable, reliable, and defensible valuation for Section 409A compliance.

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THE QUANTITATIVE MARKETABILITY DISCOUNT MODEL IN COURT AGAIN

UPDATED QMDM FACT SHEET

UPDATED QMDM FACT SHEET

Download this complimentary summary of the history of the QMDM and its acceptance in the business appraisal profession from www.mercercapital.com

In *Juan Armstrong v. LaSalle Bank National Association*, No. 05-3417 (7th Cir. May 4, 2006), the U.S. Court of Appeals for the Seventh Circuit determined that the appropriate standard of review to apply when considering whether an employee stock ownership plan trustee adopts a valuation of the subject stock is the abuse of discretion standard. It noted that one method for testing a trustee's abuse of discretion is whether a marketability discount should have been applied.

In making this recommendation, the court stated:

> "There are techniques for calculating a marketability, or illiquidity, discount, see Z. Christopher Mercer, "A Primer on the Quantitative Marketability Discount Model," *CPA Journal*, July 2003, www.nysscpa.org/cpajournal/2003/0703/dept/d076603.htm, visited Apr. 6, 2006...."

Brief summary above provided by John J. Stockdale, Jr. and appeared in the Summer 2006 issue of the Business Valuation Review

MERCER CAPITAL PROFESSIONALS TRAINING THE BUSINESS APPRAISAL PROFESSION

Timothy R. Lee, ASA
New York Society of CPAs Business Valuation Conference » May 21, 2007
"Application of Industry & Economic Data in Business Valuation"

Travis W. Harms, CFA, CPA/ABV
FCG University » April 23, 2007
"A Theoretical and Practical Review of the DCF Method"

Z. Christopher Mercer, ASA, CFA
The Institute of Business Appraisers 2007 Annual Conference » June 21, 2007
"Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?"

Travis W. Harms, CFA, CPA/ABV
Advanced Business Valuation Seminar sponsored by the American Society of Appraisers » July 18, 2007
"Developing Reliable Valuation Models"

Brent A. McDade, CBA, BVAL
ABA Family Law Section Memphis Fall Conference » October 10 - 13, 2007
"Creative Uses of Business Appraisers in Divorce"

The Integrated Theory of Business Valuation - SECOND EDITION
by Z. Christopher Mercer, ASA, CFA and Travis W. Harms, CFA, CPA/ABV
Published by Wiley & Sons
To be published in October, 2007

Title	Description	Investment	Release Date
Quantifying Marketability Discounts ***Valuing Shareholder Cash Flows***	*Quantifying Marketability Discounts* has been updated and is now offered as an e-book. This edition provides a brand new chapter which discusses each of the 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 QMDM in spreadsheet format.	**$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*
Are S Corporations Worth More Than C Corporations?	An e-booklet that adds to the S Corporation vs. C Corporation debate.	**$19.95**	*Currently available*
Embedded Capital Gains ***The History and the Issues***	A closer look at the embedded capital gains issue.	**$19.95**	*Currently available*
Employee Stock Option Valuation Issues	We have compiled some of our latest thinking on the subject of valuation of employee stock options.	**Complimentary**	*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*
The QMDM Fact Sheet	A summary of the history of the QMDM and its acceptance in the business appraisal profession. Updated as of February, 2007.	**Complimentary**	*Currently available*

New Series: "Understand the Value of Your ..."

Understand the Value of Your Auto Dealership	While death and taxes may be the only things that are truly certain, it is equally certain that the ownership of every business will eventually change hands. If we can agree that you will not own your business forever, then we should also be able to agree that it is important for you as a business owner to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved, whether you like it or not! Because your business will change hands, it is important for you to understand the key concepts of business value and how value is determined for your business.	**Complimentary**	*Currently available*
Understand the Value of Your Wholesale Distributorship of Malt Beverage Products	The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. Why is this so? After all, beer distributors are typically street wise and business savvy. They increasingly employ skilled professionals at all levels of their organizations and the evolving disciplines of their trade are largely mandated by sophisticated, international breweries. Indeed, given the scrutiny of the IRS, the control of the breweries, the evolution of product mix, and the wide ranging concerns of shareholders, it is critical that value be determined and articulated in a credible fashion. The purpose of this article is to provide insight into the situational (when and why) and analytical (how) aspects of valuing beer distributorships.	**Complimentary**	*Currently available*

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MERCER CAPITAL ON THE ROAD

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

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- 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.

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- 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.

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