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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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?
• 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?