8 Things You Need to Know About Section 409A

1. To whom does Section 409A apply?

Section 409A applies to all companies offering nonqualified deferred compensation plans to employees. We are not attorneys, so we will leave the legal minutiae of that definition for others to grapple with, noting only that generally speaking, a deferred compensation plan is an arrangement whereby an employee (“service provider” in 409A parlance) receives compensation in a later tax year than that in which the compensation was earned. “Nonqualified” plans exclude 401(k) and other “qualified” plans.

What is interesting from a valuation perspective is that stock options and stock appreciation rights (SARs), two common forms of incentive compensation for private companies, are potentially within the scope of Section 409A. The IRS is concerned that stock options and SARs issued “in the money” are really just a form of deferred compensation, representing a shifting of current compensation to a future taxable year. So in order to avoid being subject to 409A, employers (“service recipients”) need to demonstrate that all stock options and SARs are issued “at the money” (i.e., with the strike price equal to the fair market value of the underlying shares at the grant date). Stock options and SARs issued “out of the money” do not raise any particular problems with regard to Section 409A.

2. What are the consequences of Section 409A?

Stock options and SARs that fall under Section 409A create problems for both service recipients and service providers. Service recipients are responsible for normal withholding and reporting obligations with respect to amounts includible in the service provider’s gross income under Section 409A. Amounts includible in the service provider’s gross income are also subject to interest on prior underpayments and an additional income tax equal to 20% of the compensation required to be included in gross income. For the holder of a stock option, this can be particularly onerous as, absent exercise of the option and sale of the underlying stock, there has been no cash received with which to pay the taxes and interest.

These consequences make it critical that stock options and SARs qualify for the exemption under 409A available when the fair market value of the underlying stock does not exceed the strike price of the stock option or SAR at the grant date.
3. What constitutes “reasonable application of a reasonable valuation method”?

For public companies, it is easy to determine the fair market value of the underlying stock on the grant date. For private companies, fair market value is not available upon opening the Wall Street Journal each morning. Accordingly, for such companies, the IRS regulations provide that “fair market value may be determined through the reasonable application of a reasonable valuation method.” In an attempt to clarify this clarification, the regulations proceed to state that if a method is applied reasonably and consistently, such valuations will be presumed to represent fair market value, unless shown to be grossly unreasonable. Consistency in application is assessed by reference to the valuation methods used to determine fair market value for other forms of equity-based compensation. An independent appraisal will be presumed reasonable if “the appraisal satisfies the requirements of the Code with respect to the valuation of stock held in an employee stock ownership plan.”

A reasonable valuation method is to consider the following factors:

» The value of tangible and intangible assets
» The present value of future cash flows
» The market value of comparable businesses (both public and private)
» Other relevant factors such as control premiums or discounts for lack of marketability
» Whether the valuation method is used consistently for other corporate purposes

In other words, a reasonable valuation considers the cost, income, and market approaches, and considers the specific control and liquidity characteristics of the subject interest. The IRS is also concerned that the valuation of common stock for purposes of Section 409A be consistent with valuations performed for other purposes.

4. How is fair market value defined?

Fair market value is not specifically defined in Section 409A of the Code or the associated regulations. Accordingly, we look to IRS Revenue Ruling 59-60, which rather famously defines fair market value as “the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

5. Does fair market value incorporate a discount for lack of marketability?

Among the general valuation factors to be considered under a reasonable valuation method are “control premiums or discounts for lack of marketability.” In other words, if the underlying stock is illiquid, the stock should presumably be valued on a non-marketable minority interest basis.

This is not without potential confusion, however. Stock issued to ESOP participants is generally covered by a put right with respect to either the Company or the ESOP. Accordingly, business appraisers often apply marketability discounts on the order of 0% to 10% to ESOP shares. Shares issued pursuant to a stock option plan may not have similar put rights attached, and therefore may warrant a larger marketability discount. In such cases, a company that has an annual ESOP appraisal may not have an appropriate indication of fair market value for purposes of Section 409A.
6. Are formula prices reliable measures of fair market value?

In addition to independent appraisals, formula prices may, under certain circumstances, be presumed to represent fair market value. Specifically, the formula cannot be unique to the subject stock option or SAR, but must be used for all transactions in which the issuing company buys or sells stock.

7. What are the rules for start-ups?

For purposes of Section 409A compliance, start-ups are defined as companies that have been in business for less than ten years, do not have publicly traded equity securities, and for which no change of control event or public offering is reasonably anticipated to occur in the next twelve months. For start-up companies, a valuation will be presumed reasonable if "made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors prescribed for valuations generally under these regulations." Further, such a valuation must be performed by someone with "significant knowledge and experience or training in performing similar valuations."

This presumption, while presented as a separate alternative, strikes us a substantively and practically similar to the independent appraisal presumption described previously. Some commentators have suggested that the valuation of a start-up described in the preceding may be performed by an employee or board member of the issuing company. We suspect that it is the rare employee or board member that is actually qualified to render the described valuation.

8. Who is qualified to determine fair market value?

A reliable independent appraisal will be prepared by an individual or firm that has a thorough educational background in finance and valuation, has accrued significant professional experience preparing independent appraisals, and has received formal recognition of his or her expertise in the form of one or more professional credentials (ASA, ABV, CBA, CVA, or CFA). The valuation professionals at Mercer Capital have the depth of knowledge and breadth of experience necessary to help you navigate the potentially perilous path of Section 409A.

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Much has been written and said about the Quantitative Marketability Discount Model (QMDM) – some of it positive, and some not. While some may think of it as a proprietary “black box,” we contend that the QMDM is simply a shareholder-level discounted cash flow model (DCF).

Rule 9-4(d) of the 2006 USPAP Standards (effective July 1st) states: “an appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of the extent to which the interest appraised contains elements of ownership control and is marketable and/or liquid.” In a comment to this section, it states “an appraiser must analyze factors such as holding period, interim benefits, and the difficulty and cost of marketing the subject interest.”

To our knowledge, the QMDM is the only tool available to you to comply with this new standard. In this webinar, Chris Mercer and Travis Harms will demystify the QMDM and give you tools to understand, use, and defend it.

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