IRS Code Section 409A and Valuation

Under IRS Code Section 409A, options granted by companies must be valued at their fair market values on the date of their granting.

Prior to 409A, boards were able to establish option prices assuming they employed reasonable methods. Now, valuations can be conducted by companies as before; however, if the IRS determines, after-the-fact, that option exercise prices are below fair market value, the burden will be on the go-it-alone company to prove that its stock valuation method was reasonable.

Given the teeth of 409A (20% additional tax on the optionee, regular income taxes and employment taxes, and possibly interest charges), do-it-yourself the old way is not really a viable option. What, then, are the choices for valuing options in the new world of Section 409A?

According to 409A, there are three ways to obtain the "presumption of reasonableness" for your option valuations — not in order of appearance in the Code.

**Presumption 1 -- Binding Formula.** A valuation based on a binding formula used in a shareholder agreement would be considered to be fair market value if the stock is valued in the same manner for any other transfer of shares of the same or substantially similar class of stock. This would include all noncompensatory purposes requiring the stock to be valued -- including regulatory filings, loan covenants, issuances to and repurchases of stock from other than "service providers" (those receiving options).

[Because of these restrictions, this option is not likely to be used frequently.]

**Presumption 2 -- Illiquid Start-up Valuation.** A valuation made "reasonably and in good faith" of an illiquid, start-up company can enjoy the presumption of reasonableness if it meets certain requirements, including:

1. The valuation must be provided in a written report.

2. The valuation takes into account the "basic valuation factors" noted in 409A, which include:
   a. The present value of expected future cash flows of the company.
   b. The value of tangible and intangible assets of the corporation.
c. Comparisons with the stocks of reasonably similar publicly traded companies or comparisons with transactions involving similar companies.

d. Control premiums or marketability discounts.

e. Whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors.

f. Whether all relevant (material) information available to the company is considered in the valuation.

g. Whether the valuation has been updated to include consideration of information after the date of the calculation that could materially affect the value of the corporation.

h. The valuation must be less than 12 months old when used (assuming there have been no material changes in the interim).

i. Whether the valuation method is consistently used for other purposes, including noncompensatory purposes.

3. The valuation is performed by a person or persons at a company "with significant knowledge and experience or training in performing similar valuations." But which officers or directors of your company wants to try to convince the IRS on this point – when they are obviously not in the business of valuing companies and are obviously not independent with respect to your company?

A company can conduct a valuation for option purposes providing that it considers the factors above. If the IRS determines that any of the factors are not considered or fulfilled, it will not be treated as made "reasonably and in good faith." In so doing, it loses the presumption of reasonableness, and the burden of proving reasonableness shifts back to the company.

[For these reasons, it is unlikely that many companies will opt for Presumption 2 and conduct their own valuations hoping to obtain the presumption of reasonableness.]

**Presumption 3 – Independent Appraisal.** A valuation conducted by a qualified independent appraiser who uses accepted valuation methods and meets the basic requirements applicable to appraisals for employee stock ownership plans (ESOPs) will be presumed to be reasonable. It must, however, have been made within 12 months and must be updated if events subsequent to the appraisal date would have a material impact on the company's valuation.

[Prudent boards and managements will undoubtedly default to Presumption 3, and will get formal appraisals from time-to-time to support their option pricing.]

At this point, let me quote Brad Feld, a venture capitalist who writes a popular blog, *Feld Thoughts*. He writes, in one of many posts on 409A, "So what’s the big deal?":

**Cost.** On the high end these valuation can cost $50,000 or so. [But don’t let this frighten you yet | Considering that the company must value options at every grant date, this can get incredibly expensive. We have some suggestions for how to solve this issue economically, but that’s a later post (more foreshadowing).]
Competency. Not wanting to be left out of the "entrepreneurial spirit of Silicon Valley," smaller valuation companies are popping up all over the map to perform these valuations at substantial discounts to the established players. The problem is that few firms (and very few people) have a great deal of history or experience in valuing private companies, so the verdict is out whether these reports will be acceptable to the IRS should they come knocking. We are getting multiple calls a day from people wanting to perform valuations and most of them we wouldn't trust to give us change back from a cash register. (As an aside, one of our companies recently completed a formal valuation and the valuation firm (presumably a reputable one) forgot to take into account liquidation preferences of the preferred stock when considering common stock payouts on mergers. Once they did this, it reduced their initial valuation by 75%. Oops.)

History. The “grandfather clause” for 409A only applies to options that have vested by 12/31/04. As a result, any option that is still unvested (or granted) after 12/31/04 has to be “fixed” (yes – another post). Therefore, if you are a typical private company that has four year vesting on stock options, you've got to fix option grants that go back as far as 2001. Groovy.

Uncertainty. The big question that everyone is grappling with is what will the results be from these formal valuations? Will they be 10 times higher? Could they even be lower? No one really know the real impact of the valuations, because no one really knows how these firms will value the companies. We've seen a couple reports so far and in one case the price was actually lower than the company was granting at, while the other company was significantly higher. Uncertainty, however breeds nervous people."

Who can you turn to? Start-ups and venture based companies, as well as private equity groups doing deals where options are issued will have an increasing need for independent appraisal of their stocks' values.

While, as Brad Feld points out, smaller valuation companies may be "popping up all over the map" to do 409A valuations, there are a number of long-established appraisal firms (like Mercer Capital, of course) that are more likely to provide satisfactory, long-term results. They have, for example:

1. Experience in the valuation of private companies, having completed thousands of appraisals over many years.

2. Staffs to handle time-sensitive and complex assignments -- and companies with multiple rounds of financing definitely have complex capital structures that must be addressed with credibility.

3. Since many 409A valuations will be used directly, or with some modification, for financial reporting purposes, the established firms will be familiar with the technical aspects of required reviews by your auditors. See the AICPA Practice Aid, Valuation of Privately-Owned Company Equity Securities Issued as Compensation. This raises an issue of the fair market value for purposes of the Internal Revenue Service versus fair value for financial reporting purposes, which will be the subject of a future post.

4. Most of the established firms will have professionals who have substantial experience in dealing with the IRS to resolve valuation issues. Their histories of successfully resolving issues should provide comfort to companies.

5. The established valuation firms should also have quality control and review procedures in place that help assure the quality, consistency and acceptability of their work products.
In conclusion. Selection of established and experienced firms to provide valuations for 409A purposes need not be as expensive as Brad Feld's concern -- at least in the great majority of situations. It is, after all, a competitive world. What you need to find is a workable combination of price and quality to meet your needs. You should not, however, have to sacrifice quality in meeting your 409A valuation requirements.

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Other 409A Resources from Mercer Capital
» “Section 409A of the Internal Revenue Service Code,” Z. Christopher Mercer, Mercer on Value, June 20, 2006
» “8 Things You Should Know about 409A,” Travis W. Harms, Value Matters™, June 8, 2006
» “Watch Out for 409A,” Eden A. Gipson, Value Matters™, February 16, 2006

This article originally appeared as a post on Mercer on Value on August 23, 2006. See www.merceronvalue.com for other 409A information.
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