Analysis Of Section 409(a) of the Internal Revenue Code

Reaching Fair Market Value for Deferred Equity Compensation

February, 2006
Introduction

Section 409A is a new section of the Internal Revenue Code that deals specifically with nonqualified deferred compensation plans. It was created as part of the American Jobs Creation Act of 2004. Under this new rule, nonqualified deferred compensation plans will encounter onerous tax consequences unless the compensation meets stringent new requirements, including that the compensation not be paid until specified dates and that the recipient have only limited rights to elect to change the timing of the payments. This Act significantly impacts equity compensation arrangements, including stock options, in addition to traditional deferred compensation arrangements.

The intent of Section 409A is strict enforcement of the constructive receipt rules applicable under such plans. Section 409A's application is broadly significant in two respects:  

1. Section 409A applies to essentially all stock-based, nonqualified deferred compensation plans, including nonstatutory stock options (NSO), stock appreciation rights (SARs) and other equity-based compensation.
2. Section 409A extends to Section 83 property-for-services transactions.

As a result, issuers must be aware that discounted stock options, stock appreciation rights (SARs) or other equity-based compensation can result in adverse tax consequences. A stock option or SAR granted with an exercise price below the fair market value of the underlying stock on the date of grant is treated as deferred compensation under the Act. This will result in:

- tax due at vesting as opposed to at exercise, as well as
- additional 20% tax on the compensation required in gross income of the optionee,
- additional interest due on tax, “equal to the interest at the underpayment rate plus one percentage point, imposed on the underpayments that would have occurred had the compensation been includible in income for the taxable year when first deferred”

Section 409(a) does not apply in the case where the option provides, by its terms, that it is automatically exercised upon one or more permissible distribution events specifically enumerated in the Act. (i.e., dates specified in advance; termination of employment; death, etc. It does not apply where there is “substantial risk of forfeiture” under the meaning of Section 83.

Section 409A generally applies to amounts deferred after December 31, 2004. However, the rules in 409A would also apply to any amounts deferred prior to that time if a “material modification” is made to the plan after October 3, 2004.

The Internal Revenue Service suspended employer and payer reporting and wage withholding requirements for calendar year 2005 with respect to deferrals of compensation under section 409A, with no assertion of penalties if employees and other service providers report and pay the tax when due for their amounts in accordance with future guidance. Interest will be assessed, however.

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5 http://www.409a.net/
Applicability and Implications

What Plans are Affected by 409A?

The new 409A rules cover any "nonqualified deferred compensation plan", which includes any plan, agreement, or arrangement that provides for the deferral of compensation. They cover the typical elective deferral compensation plans, supplemental pension plans, employment agreements with deferral provision, certain awards under equity compensation plans, such as options issued with an exercise price below fair market value, SARs and other forms of equity compensation. The rules do not cover qualified employer plans; and bona fide vacation leave, sick leave, compensatory times, disability pay, or death benefit plans.

What If A Firm Fails To Comply With The New Rules?

If a nonqualified deferred compensation arrangement fails to comply with Section 409A, all compensation (including earnings) deferred under the arrangement for the taxable year and all preceding taxable years is immediately taxable, subject to penalties and interest, except to the extent those amounts are subject to a substantial risk of forfeiture.

What Are The New Requirements For Deferred Compensation?

A nonqualified deferred compensation plan will not result in deferral of taxation unless the plan satisfies the following requirements both in form and operation:

a. Pricing: Pricing of the deferred compensation plan must be at or above the fair market value of the underlying security at the time of the grant. If fair market value is greater than the exercise price at the date of grant, this will cause the nonqualified stock option or SAR to constitute deferred compensation that is subject to Sec. 409A.

b. Distribution: The time and form of the distribution must be specified at the time of initial deferral of compensation. The plan may not distribute amounts earlier than: (1) separation from service; (2) disability; (3) death; (4) a specified time (or pursuant to a fixed schedule); (5) a change in control or (6) an unforeseeable emergency. Most importantly, conventionally-designed options and SARs would violate Sec. 409A because the holders have the discretion to elect when to exercise the right and to be paid the inherent compensation.

c. Deferral Election: Participants must elect to defer compensation for services performed during a taxable year before the beginning of that taxable year. Two exceptions are that (a) new participants of deferred compensation schemes are allowed to elect deferred compensation within 30-days of becoming eligible, and (b) performance-based deferred compensation may be elected six-months after a 12-month compensation period.

The consequence of a violation of Sec. 409A is that the holder would be taxable on the value of the option or SAR at the time of vesting (without regard to when the right is exercised), at ordinary income tax rates, plus an additional 20% penalty tax rate. Furthermore, the Section 409A taxation is not limited to the discount between the exercise price and the fair market value of the option on the date of grant, but rather on the date of vesting of each installment, as it vests.

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7 http://www.thelenreid.com/articles/article/art_224_idx.htm
Corporate Actions Required

Virtually all equity compensation schemes, with the possible exception of qualified incentive stock option plans, are affected by section 409A rules. Employers and payers reporting on form W-2 and form 1099 will begin in 2006. The following actions are indicated:

a. **Nonqualified Deferred Compensation Plans**: Companies should immediately review and identify all of their compensation arrangements to determine which ones are affected. Many will require restructuring to conform to the new guidelines.

b. **Employment Agreements**: All executive employment agreements will require a very careful and thorough review. Many will require restructuring to conform to the new guidelines.

c. **Fair Market Value Determination**: Employers have a burden to do their best not to grant equity compensation with an exercise price less than fair market value. Therefore, the immediate valuation issue is the determination of fair market value of the stock granted pursuant to a stock-based deferred compensation plan.

d. **Publicly-traded Companies**: A six-month waiting period for distributions applies only to key employees of publicly-traded companies. It is not clear whether this rule would apply to companies or affiliates of companies traded only on a foreign exchange.

e. **Distribution**: The new rules prohibit acceleration of distributions but allow new elections to delay distributions.

f. **Reporting**: The new rule will require annual reporting on Form W-2 or Form-1099 of the compensation amounts deferred.

There are many compensation and employment related issues beyond a few mentioned above, which appear to be the most critical and pressing. the Internal Revenue Service and the Treasury Department are still determining the applicability of these rules to specific cases and situations, notably the use of restricted stock units; they are considering tightening the requirements beyond what is noted here.

The trenchant point is that to continue using equity based compensation without triggering adverse tax effects, private companies require annual valuation of their equity to be used for compensation purposes.
Determination of Fair Market Value

The Internal Revenue Service has provided guidance as to what constitutes a reasonable method for valuing equity-related compensation at fair market value; Notice 2005–1 reads:

“For the purposes of determining the fair market value of the stock on the date of the grant, any reasonable valuation method may be used. Such methods include, for example, the valuation method described in § 20.2031-2 of the Estate Tax Regulations.”

Some professionals believe that the standard for value is similar to Incentive Stock Options (ISOs). Others believe that meeting the requirement of the Internal Revenue Code Section 401(a)(28)(C) is advisable; this code section requires that companies rely upon an independent appraiser to determine the valuation of a company stock held by employee stock ownership plans. Even in the case of highly illiquid small start-ups, the valuation must be performed by a person or persons with significant knowledge and experience or training in performing similar valuations. The determination of fair market value is well-established in estate tax regulations and gift tax regulations. The Code for estate tax valuations, and the associated Revenue Ruling, are discussed below.

§ 20.2031-2 Valuation of Stocks and Bonds

This regulation, in the case of listed firms, provides guidance as to the evaluation of the value of holding for estate tax purposes. In the case of a private firm where no liquid market exists, this regulation provides instruction that the fair market value must be inferred, through considering factors including:

(a) The Company’s net worth;
(b) The firm’s prospective earning power and dividend-paying capacity;
(c) Non-operating assets and goodwill of the business;
(d) The economic outlook in the particular industry;
(e) The Company’s position in the industry;
(f) The Company’s management;
(g) The degree of control of the business; and
(h) Other relevant factors.

However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts and circumstances of each case. Complete financial and other data upon which the valuation is based should be submitted with the [estate tax] return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

§ 20.2031-3 Valuation of interest in businesses

The net value is determined on the basis of all relevant factors including:

(a) A fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will;
(b) The demonstrated earning capacity of the business; and

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9 Fenwick & West LLP.
11 http://a257.g.akamaitech.net/7/257/2422/12feb20041500/edocket.access.gpo.gov/cfr_2004/aprqrtr/26cfr20.2031-2.htm
(c) The other factors such as the ones addressed in § 20.2031-2.

These sections of the Internal Revenue Code, as well as others dealing with the valuation of privately held companies for various tax purposes, have been quite standardized in their approach to the guidelines for valuation. In 1959, Revenue Ruling 59-60 expressed the convergence of view of the IRS and the Tax Court on the subject of valuing private enterprises for fair market value.\(^\text{12}\)

**Revenue Ruling 59-60**

The forgoing section of the code has been well established in Tax Court, and is further described in Revenue Ruling 59-60, which forms the touchstone for estate and gift valuation:

“All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 [*2] and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512(a) of the 1954 Code... Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, 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. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.”\(^\text{13}\)

Revenue Ruling 59-60 prescribes that careful analysis and appraisal of the business the economic conditions prevailing as of the valuation date, sale of stock and historical as well as prospective financial performance, form input factors for the basis of valuation, which is essentially a prophecy. “The following factors although not all-inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception
(b) The economic outlook in general and the condition and outlook of the specific industry in particular.
(c) The book value of the stock and the financial condition of the business.
(d) The earning capacity of the company.
(e) The dividend-paying capacity.
(f) Whether or not the enterprise has goodwill or other intangible value.
(g) Sales of the stock and the size of the block of stock to be valued.
(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.”\(^\text{14}\)

\(^\text{12}\) For detail on regulations, see: http://www.access.gpo.gov/nara/cfr/waisidx_04/26cfr20_04.html

\(^\text{13}\) Revenue Ruling 59-60

\(^\text{14}\) Revenue Ruling 59-60.
Practical Considerations in 409A Valuations

Establishing Fair Market Value of private firms has been an evolving practice for many years, but the tenants are well known and with long legal precedent in the tax courts. A business valuation for these purposes generally divides into major sections, with subsections that cover the factors proscribed in Revenue Ruling 59-60 including three approaches to value:

1. **Descriptive Section**, which will cover the nature and history of the business, the current situation, financial analysis, the economy, the industry, and the prospects for the future.

2. **Analytical Section**, which generally covers at least three approaches to valuation – the asset approach, the income approach, and the market approach.

3. **Valuation Section**, which generally reconciles the approaches and applies discounts or premiums for lack of liquidity and/or lack of control, considering the block of stock to be valued.

Conclusion of the report is rendering a professional opinion on the fair market value of the size of the block of stock to be valued as of the valuation date. In the case of 409A valuation, the valuation date and fair market value would be as of the date of the stock grant.

Realistically, most companies that rely on significant equity compensation plans are small and speculative companies, often backed by venture capital, that are moving new technologies or new products from the laboratory to the market. Their stable of assets are often intangible assets, such as patents to be valued through the relief of royalty or other methods, customer lists, in-place workforce, and synergies in technology that the firm possesses. These firms present some special challenges in valuation, but are not uncommon for establishing fair market value. Quite often, a lack earnings history and require substantial projections as well as significant effort to develop appropriate discount rates. Moreover, valuation of speculative companies is hampered by the lack of comparable trade sales to uniformly apply the market approach. These issues in valuation are the province of valuation specialists, and routinely subject to challenge by the Internal Revenue Service.
Conclusion

From examining the relevant literature and regulations, there appears to be little doubt that to avoid substantial tax penalties in equity base compensation, fair market value will need to be established for the firm and each grant date. This will need to be done at the frequency of award, using the established techniques and procedures that are commonly used in estate and gift tax valuation.

Companies can expect to face challenges from the Internal Revenue Service with respect to their valuation used to justify their equity compensation scheme pricing, just as estates and gift tax filings routinely face challenges in tax court. Companies that rely on equity compensation have been moved into the arena of taxation, and very similar to estates, must prudently perform a valuation and have it on file as supporting evidence, as many will be certainly challenged in the new era of Section 409A.

An expert valuation is a prudent investment to establish a reasonable, good-faith estimate of fair market value to avoid issues with the taxing authorities, alleviating the costly penalties to both the firm and the employees for lack of compliance with Section 409A. An expert valuation ultimately cannot be avoided, for those firms with any significant equity compensation will be targets for Internal Revenue scrutiny and face the daunting prospect of a post-hoc valuation where their successes may skew the court in favor of higher costs and penalties. Overall, the approach of ‘do it right the first time’ in 409A valuation is the only rational approach to ensuring against significant costs in time, energy, penalties and interest in the new era of equity compensation taxation.