Commonly Asked Questions About IRC 409A

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What is IRC 409A and what does it mean for Options?

During 2005 the IRS issued new regulations (Internal Revenue Code Section 409A) that required companies to establish that stock options were not being issued "in-the-money" or below "fair market value" as defined in IRS Revenue Ruling 59-60.

The 409A regulations were recently finalized with an effective date of January 1, 2008 but may be applied to any compensation earned or deferred after December 31, 2004.

To avoid tax event and potential penalties, a formal "valuation opinion" is required every 12 months, or more often if there is a material change in either the business or the implied market value of the common stock. The determination of fair market value can be made in several ways, but many venture capital-backed and other companies usually seek an opinion from an independent expert.

A company's stock options can be structured to be exempt from 409A regulations. If the exercise price is at least equal to "fair market value" of the option property on the grant date and the option is so-called "service recipient stock". We recommend that you consult with your attorney to properly structure your stock options to be 409A exempt. Please note that an independent valuation provides substantial advantages when structuring options to be 409A exempt.

IRC 409A has numerous other implications for companies issuing deferred compensation. This document is intended only to discuss valuation issues associated with 409A.

Is 409A directed at the company or the individual?

The 409A penalties can include additional taxes and are directed at the individual. Therefore, a company should take great care to ensure its equity-compensation plans are priced at fair market value in order to avoid non-compliance with 409A. If a company does not comply with 409A, it could be subjected to employee lawsuits.

Does 409A apply to all private companies regardless of the size of their revenues?

IRC 409A applies to all private companies that have issued nonqualified deferred compensation to employees regardless of revenues.

How do these rules apply to stock options granted before January 1, 2005?

Section 409A applies to all stock options that were not vested prior to January 1, 2005. No distinction is made based on the grant date of the option.

What are the penalties for non-compliance?

It there is a violation; a penalty can include current tax on deferrals for the current year and all prior years, interest at the underpayment rate plus 1% from original deferral date and an additional tax of 20% of the taxable compensation. If the plan is not drafted correctly, all participants could be affected and all post-2004 deferrals taxable.

What is an accuracy related penalty?

In controversies with the IRS that concern valuation issues, it is not uncommon for the IRS to assess accuracy-related penalties as allowed under IRC §6662. The penalty is applied to the portion of any underpayment of tax that is attributable to an accuracy-related issue as defined by the IRC. All accuracy-related penalties apply to tax returns due, without regard to extensions, after December 31, 1989.

Even though the IRS attempts to assess accuracy-related penalties in valuation cases, the Tax Court has consistently refused to allow these assessments when the tax payer has acted “reasonably” by engaging a valuation professional who has obtained proper training in valuation theory.

Therefore, it is extremely important that the person performing your valuation not only be independent, but also qualified to perform such a valuation.

Accounting Requirements for Valuation

IRC 409A requires an annual common stock valuation to protect employee recipients of equity compensation based on common stock from potentially serious adverse tax consequences.

Additionally, Financial Accounting Standard 123R requires that all companies determine the cost of all equity compensation, including stock options, contemporaneous with the grant or issuance. One key to determining the valuation of stock options is to determine the value of the common stock.

As a result, companies usually prepare one or more common stock valuations each year to remain in compliance with IRC 409A and FAS 123R.

How long will a valuation be valid?

All valuations under any of these methods are valid until the earlier of (i) 12 months from the valuation date or (ii) a material change in the value of the company. Any method used must be applied consistently for all valuations.

As a private company, how do we determine the fair market value of our common stock for purposes of these rules?

The regulations state that for the IRS to accept a valuation of private company common stock, it must be done by "the reasonable application of any reasonable valuation method." Factors that the IRS states should be considered for the method to be reasonable include:

- Tangible and intangible assets value;
- Net Present Value (NPV) of future cash-flows;
- Market value of stock or equity interests in similar corporations and other companies engaged in trades or businesses substantially similar to those engaged in by the company being valued, the value of which can be determined by objective means (such as through trading prices on an established market or an amount paid in an arms length private transaction);
- Other relevant factors, such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors.

The value must be determined taking into consideration all available information material to the value of the corporation, and must be calculated as of a date that is within twelve months of the date for which the valuation is being used.

What is a reasonable valuation by the IRS?

The regulations provide three specific approaches that the IRS will presume to be reasonable if consistently applied: (1) a valuation of illiquid stock of a start up company by experienced personnel and (2) a valuation based upon certain types of formulas and (3) an appraisal by an independent appraiser/valuator.

There are substantial restrictions on the validity of an appraisal if conducted by someone other than an independent appraiser. These restrictions are discussed below.

What is the "start up" valuation method?

To qualify as "illiquid stock" of a "start-up" company under the proposed regulations, the following requirements must be met:

- The valuation must be reasonable and in good faith as evidenced by a written report;
- The company (and predecessors) cannot have been in business for ten years or more;
- The company cannot be public (i.e., it cannot have any securities that are readily traded on an established securities market);
- There must not be any permanent put or call on the stock or any permanent requirement that the company or any other person purchase the stock (a right of first refusal or a repurchase right for unvested restricted stock awards is permitted);
- At the time of the valuation, it is not anticipated that the company will undergo a change in control or an initial public offering within 12 months after the valuation.

The person(s) performing the valuation of a "start-up" company must have significant knowledge and experience or training in performing similar valuations. .

What is the “formula-based” valuation method?

A formula-based valuation is presumed a reasonable method if certain requirements are met. Examples of the formula-based valuation method would be valuing the stock based on a multiple of sales or earnings, or book value.

A formula-based valuation must be consistently applied to all valuations of the stock. This is a very restrictive method and not many companies will be willing and able to qualify for this method.

Why is an Independent Appraisal and why is it important?

The Independent Appraisal is a valuation performed by a qualified independent appraiser/valuator using traditional appraisal methodologies. This is the safest way to value a company for 409A compliance purposes. The valuation is presumed reasonable if completed within 12 months of the applicable stock option grant date.

The IRS will consider written valuation performed by a person with significant knowledge and experience except if the company is more than ten years old, a liquidity event occurs within twelve months after the option grant or there are put/call rights on the stock. Most companies will find these criteria to be too restrictive.

There are other reasons to choose an independent expert:

- An opinion from an independent, third-party shifts the burden of proof for "reasonableness" from the company to the IRS
- An outside valuation firm can provide useful assistance in the event the IRS or outside auditors question the methodology or results.
- Valuations can be time-consuming. Corporate management teams have limited time to spend away from the critical path of product development and revenue generation.

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