

Section 409A Considerations and Close Corporation Stock Option Valuations

Katherine A. Gilbert and C. Ryan Stewart

Internal Revenue Code Section (“Section”) 409A involves the taxation of deferred compensation such as stock options and stock appreciation rights. Compliance with Section 409A can be challenging for the management of a closely held taxpayer corporation. Such compliance requires an understanding of the specific Section 409A requirements as they apply to the valuation of the closely held corporation. This discussion focuses on the Section 409A provisions that stipulate the (1) circumstances that require a valuation, (2) appropriate methods to use when performing the valuation, and (3) selection of qualified individuals to perform the valuation of the closely held taxpayer corporation common stock.

INTRODUCTION

Closely held corporation owners and their legal counsel should pay particular attention to the necessity of an Internal Revenue Code Section (“Section”) 409A valuation. Section 409A is often overlooked by many private company owner/entrepreneurs. Section 409A was enacted in October 2004, and the final regulations related to Section 409A were issued in April 2007.

Section 409A applies to the compensation that is earned by an employee in one year but is paid in a future year. Section 409A sets forth specific requirements that the valuation of deferred compensation should meet. Every time that close corporation stock options are issued to an employee, there should be a valuation of the corporation common stock.

This discussion considers the portions of the Section 409A regulations that apply to close corporation stock valuations when private company stock options are involved.

COMPENSATION TYPES INVOLVED WITH SECTION 409A

Nonqualified deferred compensation is different from employee compensation that is “paid” in the

form of elective deferrals to qualified plans. In addition to traditional deferral plans and SERPs, Section 409A can cover many compensation arrangements that would not normally be considered nonqualified deferred compensation.

Such compensation arrangements often include the following:

1. Stock options and other forms of equity compensation
2. Severance agreements
3. Bonus plans
4. Post-retirement reimbursements

Section 409A applies to employees, directors, partners and other contractors, regardless of compensation level.

SECTION 409A VALUATION RULES FOR THE CLOSELY HELD CORPORATION COMMON STOCK

For closely held corporation common stock that is not readily tradable, the taxpayer corporation has to use a “reasonable” application of a “reasonable” valuation method to value the subject stock.

Whether or not a valuation method is considered “reasonable” depends on the relevant facts and circumstances surrounding the subject closely held corporation as of the valuation date.

The following factors should be considered when applying a “reasonable” valuation method as specified in the Section 409A regulations:

1. The value of the taxpayer corporation tangible assets and intangible assets
2. The present value of the taxpayer corporation anticipated future cash-flow
3. The market value of stock or other equity interests in similar corporations and the market value of other entities engaged in trade or business substantially similar to the subject corporation, the value of which can be readily determined through nondiscretionary, objective means
4. Recent arm’s-length transactions involving the sale or transfer of such stock or equity interests
5. Other relevant factors such as (a) the application of valuation premiums for ownership control and valuation discounts for lack of marketability and (b) whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors

According to the Section 409A regulations, a stock valuation is not “reasonable” if it is more than 12 months old. Regardless of its age, a stock valuation is not “reasonable” if it does not take into account any material recent developments regarding the subject taxpayer corporation.

The Section 409A regulations provide limited safe harbors for taxpayers that are not confident that their internal valuations are “reasonable.”

THE SERVICE GUIDANCE AND THE SAFE HARBOR METHODS

The Section 409A regulations provide safe harbor stock valuation provisions. When one of these safe harbor provisions is used, the corporation stock valuation is presumed to be reasonable.

According to the Section 409A regulations, the Internal Revenue Service (“Service”) may rebut this presumption of reasonableness only if the stock valuation method or the stock valuation conclusion is “grossly unreasonable.”

There are three safe harbor closely held stock valuation methods provided in Regulation Section 1.409A-1(b)(5)(iv)(B)(2):

1. A stock appraisal by an independent third party appraiser
2. The use of a stock fair market value valuation formula
3. A stock appraisal by a qualified individual who does not have to be independent of the corporation; this safe harbor provision is available only for start-up companies.

Closely Held Stock Appraisal by an Independent Appraiser

The independent stock appraisal safe harbor provision is fairly unambiguous. Regulation Section 1.409A-1(b)(5)(iv)(B)(2)(i) provides that, in applying this safe harbor, the independent appraiser of the optioned stock should use the same valuation standards for the appraisal of the corporation stock.

Those valuation standards are described in Section 401(a)(28)(C) and in the accompanying regulations. These valuation standards simply state that the company stock valuation should be performed by an independent appraiser.

The Section 401(a) regulations provide no additional professional guidance with regard to closely held stock valuation approaches, methods, or procedures. Therefore, this Section 409A safe harbor provision appears to rest solely on the fact that the closely held corporation retained an appraiser who is independent of the sponsor company.

The only additional professional guidance from this safe harbor provision is a requirement that, in order for the valuation to be relied on, it should be as of a date within the past 12 months before the date of grant.

Stock Fair Market Value Valuation Formula

The second safe harbor provision is the use of a fair market value formula valuation. This safe harbor option is provided in Regulation Section 1.409A-1(b)(5)(iv)(B)(2)(ii).

At first, this provision may appear to be a very useful safe harbor option. This is especially true because many closely held corporations often use a formula to determine the subject stock fair market value. However, the taxpayer corporation may use this safe harbor provision only if several restrictive conditions are met.

First, if an employee wants to sell the corporation stock, then he or she must offer to sell the stock to the prospective buyer only at the formula value.

Second, the party that buys the corporation stock from the employee must also offer to sell the stock to the next prospective buyer only at the formula value.

Third, if anyone else holds shares in the same or similar class of corporation stock, then that individual must also use the formula value whenever he or she sells the corporation stock (1) to the corporation or (2) to someone who owns more than 10 percent of the total combined voting power of all classes of the corporation stock.

All of the above-listed formula value restrictive conditions must be permanent. However, the restrictive conditions may be lifted in the event of an arm's-length transaction involving the sale of all or substantially all of the outstanding stock of the closely held corporation.

Closely Held Stock Appraisal by a Nonindependent Person

Under the third safe harbor provision, an appraisal of the closely held stock is also required. However, the individual performing the stock valuation need not be independent of the closely held corporation.

The valuation should take into account all the fair market value factors described above. This safe harbor provision is only available for a corporation that has conducted its trade or business for less than 10 years (i.e., a start-up company).

This requirement is provided by Regulation Section 1.409A-1(b)(5)(iv)(B)(2)(iii). This safe harbor provision allows a start-up company to avoid the cost of an independent stock appraisal.

This third safe harbor provision is not available if either the taxpayer corporation or the employee reasonably anticipates that the corporation will undergo:

1. a change in ownership control event in the next 90 days or
2. an initial public offering of the corporation stock within the next 180 days.

The reason for these exclusions seems to be that such change of control events have the potential to cause a major change in the taxpayer corporation stock value.

In addition, this third safe harbor provision may not be used if the taxpayer corporation stock is subject to any put, call, or other right to purchase the company stock.

However, these stock transferability restrictions exclude:

1. a right of first refusal to an offer to purchase the corporation stock by an unrelated third party or
2. a nonpermanent right to sell or buy the corporation stock at a formula value (i.e., a lapse restriction).

In this safe harbor provision, the person who performs the valuation does not have to be independent of the closely held corporation. However, that person must be qualified to perform such a stock valuation based on significant knowledge, experience, education, or training.

In the regulations, the term "significant experience" is defined to mean at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the taxpayer corporation operates.

In addition, the valuation analyst should be the type of individual that the taxpayer corporation "would reasonably rely on" for advice "regarding the purchase or the sale of the stock being valued."

SUMMARY AND CONCLUSION

Section 409A has reformed the way in which private companies issue stock options. There is no one stock option pricing or valuation answer that is applicable to all taxpayers.

By consistently and reasonably applying one of the above-mentioned safe harbor methods, the valuation burden of proof is shifted from the taxpayer corporation to the Service. And, the Service must then prove that the safe harbor valuation methods used were grossly unreasonable.

Katherine Gilbert is a senior associate in our Atlanta office. She can be reached at (404) 475-2312 or at kagilbert@willamette.com.

C. Ryan Stewart is a manager in our Atlanta office. He can be reached at crstewart@willamette.com or at (404) 475-2318.

