The Issue

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409A

What it is and why do we need one?

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Valuation of Privately-Owned Businesses

Most owners of private businesses wonder what the value of their business is, from time to time. Some times this may just be a passing thought, but frequently there are serious reasons to consider having a formal valuation of a business. Some of those reasons include:

- Pricing employee stock options
- Shareholder buyouts
- Internal sales and purchases
- Buy/sell agreements
- Estate planning and gifting
- Fund raising from potential investors
- Merger and acquisition activity

In future editions of **The Issue**, we will discuss a number of these valuation issues, but initially, we would like to focus on the first item, "Pricing employee stock options". This "form" of valuation is commonly referred to as a "409A valuation" with its title coming from the Internal Revenue Code Section 409A that regulates the treatment of all forms of "nonqualified deferred compensation". A nonqualified deferred compensation plan is generally any compensation arrangement that provides for the deferral of compensation. Since stock-based compensation can fall squarely within the scope of 409A, these rules have significantly affected the manner in which private companies set the exercise prices for employee stock options.

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Here is the key!

<u>The "fair market value rule</u>"

<u>IRC Section 409A and other Code Sections require that employee stock options be priced at exercise prices that are at (or above) the fair market value of the underlying stock on the grant date</u>

How is that best done? Here are some issues that a company needs to consider when determining the correct approach to a valuation:

- The fair market value must be determined using "reasonable application of a reasonable valuation method."

- The IRS regulations state that the valuation can be performed by a person internal to the company who has "significant knowledge and experience or training in performing similar valuations," creating a written valuation report detailing the accurate pricing of the common stock, etc. But the company will have to prove that the internal person doing the valuation is "qualified" and IRS hasn't given clear guidelines for this.

"<u>But is there a "Safe Harbor' for the company</u>?"

- By using a "qualified third party valuation", the company can shift the burden of proof onto the IRS to prove that the option exercise price was not set at or above fair market value, and that the valuation is "grossly unreasonable". In all other cases, the company has the burden of proving that its stock valuation method was reasonable and complied with the regulations.

<u>"So what are the penalties for non-compliance</u>?"

There are some caveats and exceptions, but basically, if a company fails to meet the fair market value rule in pricing stock options the employee loses the benefits of the preferred tax status of an incentive stock option (ISO), is taxed when the option vests rather than on the date of exercise, is taxed at ordinary income tax rates rather than capital gains, and there can be additional 20% penalty, as well as a potential increased interest charge. There can also be penalties assessed against the company.

So there is a strong case to be made for using an independent third party to do the 409A valuation.

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And what is a 409A valuation?

Since there are no specific IRS rules for doing 409A valuations, the AICPA has stepped in to the breech and conveniently summarized the viable valuation methods in the AICPA's Valuation of Privately-Held Company Equity Securities Issued as Compensation (the "Guidance"). While the Guidance had its origin in the financial reporting realm, it provides a good summary of the required considerations in an equity valuation for tax purposes.

Some specific guidance factors

The AICPA includes factors that the valuation specialist considers in performing a valuation, which include:

- Milestones achieved by the enterprise
- State of the industry and the economy
- Experience and competence of management team and board of directors
- Marketplace and major competitors
- Barriers to entry
- Competitive forces
- Existence of proprietary technology, products, or services
- Work force and work force skills
- Customer and vendor characteristics
- Strategic relationships with major suppliers or customers
- Major investors in the enterprise
- Enterprise cost structure and financial condition
- Attractiveness of industry segment
- Risk factors faced by the enterprise
- Other qualitative and quantitative factors

Three Approaches

The "guidance" suggests three approaches for determining value at the enterprise level market, income, and asset approaches. Valuation specialists generally consider more than one valuation technique in estimating fair value and selecting valuation technique(s) that are appropriate for the circumstances. It is common for the results of one valuation technique to be used to corroborate or otherwise be used in conjunction with one or more other valuation techniques.

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- The market approach bases the value measurement on market data; for example, values for comparable public companies or similar transactions. Another method within the market approach derives an indication of the total equity value from a recent transaction involving the company's own securities; for example, a recent financing round.

- The income approach seeks to convert future economic benefits into a present value for the enterprise.

- The asset approach estimates the value of an enterprise based on the principle that the enterprise value is equivalent to the values of its individual assets net of its liabilities.

Allocation among equity classes

Normally, a valuation specialist determines the fair value of a minority interest in an enterprise's privately issued securities by first determining the value of the enterprise and then allocating that value among the various equity classes of the enterprise. The allocation requires an understanding of preferred stock rights, which comprise both economic and control rights.

Adjustments

In standard valuation theory, value may be measured on a controlling or minority-interest basis and on a marketable or nonmarketable basis. Adjustments to the value may be needed when estimating the fair value of an interest on a specified basis. The appropriate basis of valuation varies depending on the objective of the analysis.

Report

The AICPA recommends that a valuation report be written so as to enhance management's ability to:
- evaluate the valuation specialist's knowledge of the enterprise and the industry.
- determine whether the valuation specialist considered all factors relevant to the valuation.
- understand the assumptions, models, and data the valuation specialist used in estimating fair value; evaluate for reasonableness those assumptions and data; and evaluate for appropriateness those models.

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There is more

What the "guidance" doesn't cover is the need for the valuation specialist to work closely with key members of management and the board to be sure that they understand the process, procedures and conclusions and how they impact the company and its financial status and plans.

Actually, this should start before the process begins so that the company also understands the costs, because they are on-going. Valuations are required at least ***annually*** for companies issuing stock options regularly and more frequently if there are significant events that materially impact the company.

Summary

Are you a private company that is issuing stock options to its employees? Need a 409A valuation? Consult your legal counsel and CPA as to whether you need an independent appraisal.

Then call Ed O'Dea at (925) 899-2093.

Ed O'Dea is a former CFO/COO with significant experience in general and financial management, debt & equity financing, mergers and acquisitions and strategic and financial planning with particular emphasis in the start-up environment. He has a solid understanding of all corporate functions from sales and marketing, to human resources and accounting and reporting which he adeptly applies to the solutions and counsel that he provides his clients

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