Indé Global
Business Appraisers

Valuation updates | Applicability of section 409A

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This thought leadership paper provides insights on the requirements and applicability of section 409A valuations.

Applicability of Section 409A

Section 409A (the "Section") applies to compensation that employees earn in one year but is paid in a future year. It sets forth specific requirements that the valuation of deferred compensation should meet. For closely held corporations whose stocks are not readily tradeable, the section requires a "reasonable" application of a "reasonable" valuation method to value the subject stock.

According to Section 409A regulations, the Internal Revenue Service ("IRS") may rebut the presumption of reasonableness only if the stock valuation method or the stock valuation conclusion is "grossly unreasonable". Thus, the burden of proof is passed on to the IRS that the exercise price was not at or above the fair market value when the valuation method used is "reasonable".

General Conditions

According to Section 409A regulations, a valuation method is not reasonable if:

- It is more than 12 months old
- It does not take into consideration any material recent developments regarding the taxpayer corporation regardless of age

Safe Harbors

A **safe harbor** is a provision of a statute or a regulation that specifies that certain conduct will be deemed not to violate a given rule. In context of the Section regulations, a safe harbor is a closely held stock valuation method which is presumed to reasonable according to IRS. Following is the summary of closely-held corporation stock valuation methods provided in the safe harbor:

I.STOCK APPRAISAL BY AN INDEPENDENT APPRAISER

Guidelines

- The independent appraiser should value the optioned stock using the same valuation standards applicable to the corporation stock. The valuation standards mentioned in Section 401(a)(28)(C) state that the company stock valuation should be performed by an independent appraiser.
- The valuation should be as at a date which is within the past 12 months before the date of grant.

II. STOCK FAIR MARKET VALUATION FORMULA Guidelines

This safe harbor provision can be used only if the following conditions met:

- 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.
- 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.
  - If anyone else (other than employee) 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

These conditions need not be considered in the event of an arm's- length transaction involving the sale of all or substantially all of the outstanding stock of the close-held corporation. Thus this provision will be applicable even if the above conditions are not satisfied.

STOCK APPRAISAL BY A NON-INDEPENDENT APPRAISER (APPLICABLE ONLY TO START-UPS [1])

Guidelines

As the name suggests, the individual performing the valuation need not be independent of the closely held corporation. Hence, this provision allows a start-up to avoid the cost of an independent stock appraisal.

This safe harbor provision is not applicable if the corporation or the employee reasonably estimates that the corporation will undergo:

- A change in ownership control event in the next 90 days or;
- An IPO of the corporation stock in the next 180 days

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Applicability of section 409A

This provision **may** not be used if the taxpayer corporation stock is subject to any put, call or other right to purchase the company stock [2]

Under this provision, the person performing the valuation must be qualified to perform such a stock valuation based on significant knowledge, experience [3], education or training. The regulations also clarify that the standard to be applied is whether a reasonable individual, upon being apprised of such person's relevant knowledge, experience, education and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued.

The final regulations adopt a presumption in specified circumstances that, for purposes of section 409A, a valuation of stock reflects the fair market value of the stock, rebut-table only by a showing that the valuation is grossly unreasonable. The presumption applies where the valuation is based upon an independent appraisal, a generally applicable repurchase formula (applicable for both compensatory and non-compensatory purposes) that would be treated as fair market value under section 83, or, in the case of liquid stock of a start-up corporation, a valuation by a qualified individual or individuals applied at a time that the corporation did not otherwise anticipate a change in control event or public offering of the stock.

Footnotes

[1] According to Section 409A, a start-up is a corporation that has conducted its trade or business for less than ten years.

[2] These stock transfer restrictions exclude a right of first refusal to purchase the corporation stock by an unrelated third party or a non-permanent right to sell or buy the corporation stock at formula value

[3]According to the regulations, significant experience means 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.

About us:

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