

409A Valuations

Internal Revenue Code Section 409A

If your company has issued stock options, phantom stock, stock appreciation rights, or restricted stock to employees as deferred compensation, you may fall under the scrutiny of Internal Revenue Code Section 409A (IRCS 409A). IRCS 409A requires the deferred compensation to have an exercise price of securities awarded as deferred compensation to be greater than or equal to the fair market value at the time the award is granted. A valuation of the securities awarded therefore needs to be performed.

What does IRCS 409A mean to me?

A qualified independent valuation firm should be engaged to perform a valuation of the equity-based compensation given to employees to avoid potential tax penalties. If you fail to comply with IRCS 409A, the compensation is subject to certain additional taxes and potential penalties, including a 20 percent additional income tax that is due immediately.

IRSC 409A provides a “safe-harbor” and presumes a valuation to be reasonable if the stock is valued under one of three ways:

- An appraisal is performed by an independent appraiser within 12 months of the grant date, and if no material changes have occurred between the appraisal date and the grant date
- The use of an existing binding fair value formula for the equity compensation
- A valuation made reasonably and in good faith for an illiquid, start-up company by a qualified individual (this individual does not need to be independent for start-up companies)

If one of the above criteria is met, the value is presumed to be reasonable unless the IRS can show that the value was grossly unreasonable. This puts the burden back on the IRS and not your company. For most equity-based compensation plans, you will need to hire an independent appraiser in order to shift the burden back to the IRS.

How is a valuation for 409A purposes performed?

- The appraisal will be similar to other appraisals performed under the fair market value standard of value
- The appraisal will consider the cost, market and income approaches to value
- The appraisal will consider the appropriateness of discounts for lack of control and lack of marketability
- The appraisal will generally be as of the grant date of the equity compensation

Why Gordon Brothers?

Gordon Brothers has valued numerous equity interests for privately-held companies. Let us perform your independent appraisals, and avoid the risk of additional taxes and penalties from the IRS.