

Burkert Valuation Advisors, LLC

VALUATION AND LITIGATION CONSULTANTS

Spotlight on Value: Private Company Valuation Issues Created by IRC § 409A

by Rod P. Burkert, CPA/ABV, CVA

Introduction

IRC § 409A tightens up federal tax rules governing deferred compensation and imposes tax penalties on non-compliant deferred compensation arrangements. Such arrangements will now include discounted (i.e., having an exercise price that is less than the fair market value of the underlying stock measured as of the date of grant) compensatory stock options and stock appreciation rights. A 20% tax penalty can be applied to the employee-recipient of a non-complying award. There could also be exposure for the company, including its controlling persons under some circumstances, for failure to withhold on or timely report income amounts deemed includable with respect to such an award. All of this begs the question: For purposes of setting the exercise price, what is the fair market value of the stock of the private company?

409A Valuation Alternatives

409A Proposed Regulations state that the stock of a private company stock must be determined by a “reasonable application of a reasonable valuation method.” This method(s) must be applied on a consistent basis and will influence the way private company stock valuations are conducted to ensure that companies are not inadvertently granting discounted stock option awards.

The Proposed Regulations set forth alternatives to value “stock not readily tradable on an established securities market.” A valuation, “made reasonably and in good faith and evidenced by a written report” that takes into account all relevant facts and circumstances, is appropriate for the “illiquid stock of a start-up corporation.” Stock will be treated as “illiquid stock of a start-up corporation” if (1) the company has not conducted a trade of business for 10 or more years, (2) the company has no class of equity securities which is traded on an established securities market, (3) the stock is not subject to certain put or call rights or obligations, and (4) the company is not reasonably expected to undergo a change in control or public offering within 12 months of the valuation date. The valuation must be “performed by a person or persons with significant knowledge and experience or training in performing similar valuations.” Presumably, this type of valuation could be performed by a board member or a member of management having such qualifications.

If all of the above four conditions are not satisfied, the Proposed Regulations require that the valuation be determined by “an independent appraisal.” Presumably, this type of valuation would have to be performed by a person or persons not associated with the company.

Valuation Methods

A valuation for 409A is essentially a tax-purpose valuation, requiring consideration of all relevant factors noted in Revenue Ruling 59-60. The valuation should include the asset approach, which may be appropriate only for very early stage development companies; the income approach, most likely using a discounted cash flow analysis requiring management projections; and the market approach, which would consider the latest round of financing, guideline public companies, and recent M&A transactions. There will be a presumption of reasonableness of such methods by the IRS unless it shown that either the valuation method or the application of such method was “grossly unreasonable.”

Shelf Life of Valuations

Under the Proposed Regulations, a valuation to establish the value of the underlying stock in connection with one or more stock option awards would have a shelf life of no more than 12 months. An update would be required at least annually and more often (1) if there is a material change that affects company value (e.g., achieving a milestone, obtaining new financing, granting of a patent, or settling litigation) and (2) if new options are to be granted (perhaps as a result of the material change).

Effective Date of 409A

Generally, amounts deferred after December 31, 2004 are subject to 409A; amounts deferred and vested on/before December 31, 2004 will continue to be subject to the old rules. The Proposed Regulations issued in September 2005 are expected to become effective for taxable years beginning on/after January 1, 2007. However, early adoption offers companies an opportunity to establish valuations now that will be presumed reasonable under the Proposed Regulations.

Other Considerations

Discussions with the company’s outside auditors should be held early on to determine if the 409A valuation report will also be used for SFAS 123R purposes and , if so, that the form of the report be sufficient for the auditors’ documentation requirements.

Rod is a co-founder of Burkert Valuation Advisors, LLC. With over 25 years of combined experience in public accounting and private industry, he has provided business appraisal and litigation consulting services for companies operating in a wide variety of industries and for various purposes. He is also an instructor for the National Association of Certified Valuation Analysts and a past chairman of its Executive Advisory Board and its Education Board.

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