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Private Company Stock Options & Section 409A: The Road to Compliance

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Is your company unclear about what Section 409A of the Internal Revenue Code is and how it will impact your stock option plans? Maybe you're familiar with the statute but need more time to become 409A-compliant.

Good news: While the effective date for the final Section 409A regulations remains January 1, 2008, the Internal Revenue Service (IRS) recently provided for additional "transition relief" that generally puts off the deadline for compliance with the final regulations until December 31, 2008.

Section 409A was added to the Internal Revenue Code as a result of the American Jobs Creation Act of 2004. More than two years later, in April 2007, final regulations under Section 409A were issued.¹ Section 409A establishes rules concerning the taxation of nonqualified deferred compensation (NQDC) arrangements. The statute imposes harsh non-compliance penalties on service providers, whereas the consequences of non-compliance for service recipients are much less severe.²

The provisions of Section 409A are onerous and apply to all NQDC arrangements³ (written and unwritten) including, for example, certain nonqualified stock options.

This article is intended as a compendium of Section 409A as it pertains to stock options granted by private companies. A comprehensive analysis of the entire statute is beyond the scope of this article.

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Options Not Subject to Section 409A Coverage

Private companies may grant either statutory stock options (e.g., an incentive stock option or ISO) or nonstatutory (commonly referred to as nonqualified) stock options [see [Table 1](#) (PDF)].

For a nonqualified stock option (NSO) to be exempt from Section 409A, it must not provide for the deferral of compensation. An option generally will not provide for the deferral of compensation if the exercise price may never be less than the fair market value of the stock on the date of grant, and the number of shares subject to the option is fixed on the date of grant. Accordingly, an NSO granted "at-the-money" or "out-of-the-money" (collectively referred to in Section 409A as nondiscounted stock options) will generally be exempt from 409A.

ISOs are generally not covered by Section 409A. However, there are circumstances where an ISO might be considered an NSO, and therefore be subject to Section 409A.⁴

Options Subject to 409A Coverage

For options that do not comply with Section 409A (e.g., an NSO that is "in-the-money" on the date of grant), deferral amounts become taxable when they are no longer subject to a substantial risk of forfeiture. Therefore, compensation with respect to such a stock option generally becomes taxable in the year in which the option vests, regardless of whether the option is ever exercised. The taxable amount is based on the difference between the stock's then fair market value and the option's exercise price (i.e., the so-called spread). This can pose a problem for service providers as taxation precedes any cash-flow event relative to the option.

In addition to paying income tax when a noncompliant option vests, a service provider will also be subject to an additional 20 percent excise tax and interest [see [Table 2](#) (PDF)]. Contrast this unfavorable result with the pre-409A landscape, where at worst an option intended as an ISO might be determined to be an NSO, therefore causing the service provider to lose the preferential tax treatment.

The tax consequences to the service recipient are generally limited to potential penalties for failure to withhold for the applicable income and excise taxes (and the accompanying FICA tax). Considering that compliance is generally in the hands of the service recipient, Section 409A is unique in its harsh treatment of the service provider.

Even when an option is not otherwise 409A-compliant, restrictive exercise provisions (among other requirements) can save the service provider and service recipient from the adverse tax consequences. This involves allowing the option to be exercised only at specified times permitted by Section 409A, such as a predetermined date or upon a change in control or termination of employment. Not all service providers, however, will view this as an attractive solution.

Determining Fair Market Value

For a private company seeking exemption from Section 409A, the manner in which it determines (and documents) the fair market value of its stock is of utmost importance because an NSO with an exercise price that is at least equal to the stock's fair market value on the date of grant generally will not be subject to Section 409A.

The final regulations specify that the fair market value of stock not readily tradable on an established securities market may be determined through "the reasonable application of a reasonable valuation method." While this phrasing may seem similar to the "good faith attempt" requirement that applies to ISOs under Section 422⁵, the requirements under Section 409A are much more stringent. For certain, the days of subjective, undocumented, board-determined share valuations are over.

Whether a valuation method is reasonable or not depends on the facts and circumstances existing as of the valuation date and whether or not all information material to the valuation has been considered. The final regulations⁶ set forth certain factors that, at a minimum, must be considered when valuing the stock of nonpublic companies. They include:

1. The value of the company's tangible and intangible assets
2. The present value of its anticipated future cash-flows
3. The market value of equity interests in entities engaged in trades or businesses substantially similar to those engaged in by the company whose shares are being valued
4. Recent arm's length transactions involving the sale or transfer of the company's stock
5. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors

The final regulations⁷ provide private companies with three presumptively reasonable (or "safe harbor") valuation methods, which are subject to rebuttal by the IRS only if the method or its application is determined to be "grossly unreasonable." One safe harbor method involves obtaining an independent appraisal of the service recipient's stock. Another is the use of a generally-applicable repurchase formula, provided that such formula is applied consistently and used by the service recipient in a uniform manner for all purposes (compensatory and noncompensatory).

The third safe harbor method deals with the "illiquid stock of a start-up corporation." Start-up corporations are generally those that are less than 10 years old and whose stock is not traded on an established securities market or subject to put or call rights. Note, however, that this safe harbor method will not apply when a change in control is expected within 90 days of the valuation date. Similarly, if an IPO is expected within 180 days, the service recipient will not qualify for the start-up safe harbor.

When a private company does meet the definition of a start-up, the fair market value of its shares can be determined in house, provided that it is in writing and addresses the five factors enumerated above. The individual performing the valuation, however, generally must possess at least five years of business valuation or other relevant experience specific to the industry in which the service recipient operates.

Transition Relief

But if compliance with the final regulations is not required until 2009, what valuation guidance should be followed by private companies in the interim? Prior to 2009 (i.e., during the transitional good faith compliance period) NQDC plans should be operated in compliance with Notice 2005-1⁸ or other applicable guidance (e.g., the proposed Section 409A regulations). While compliance with the final regulations prior to 2009 is not required, it would nonetheless be viewed as reasonable, good faith compliance with the statute. Reliance on the proposed regulations will constitute reasonable, good faith compliance with the statute only through December 31, 2007. So ... in what ways then are Notice 2005-1, the proposed regulations, and the final regulations different?

As to valuation of stock not readily tradable on an established securities market, Notice 2005-1 permits the use of "any reasonable valuation method." The proposed regulations identify key factors that the IRS would use to assess the reasonableness of a valuation method and also introduce the three safe harbor valuation methods. The final regulations are similar to the proposed regulations, but refine the guidance in certain areas.

For instance, the final regulations clarify what qualifications are needed for a start-up company valuation to be performed internally. In addition, the final regulations relax the change of control and IPO time horizon requirements for the start-up safe harbor, dropping the former to 90 days and the latter to 180 days (both were one year under the proposed regulations). The final regulations also add that a reasonable valuation method must consider recent arm's length transactions in a company's stock (a factor not present in the proposed regulations).

Frequency of Valuation

Generally, a valuation can be relied on for 12 months under Section 409A. For example, a private company stock valuation as of December 31, 2007, could be used to establish the exercise price of options granted from January 1, 2008, to December 31, 2008. However, private companies must constantly monitor changing facts and circumstances. When a significant event occurs (e.g., the company closes on a new round of financing or achieves positive cash flow for the first time), serious consideration should be given to conducting a new valuation.

Even when there is no such milestone, companies in high-growth periods may not be comfortable relying on a valuation that is, for example, 11 months old. Depending on the facts and circumstances, companies may deem it prudent to value their shares semi-annually or quarterly.

Another way private companies can address the frequency issue is to limit the number of times per year that they grant options. As a simplistic (but perhaps impractical) example, a company might grant options once each year to coincide with the effective date of its share valuation.

Conclusion

Section 409A of the Internal Revenue Code is complex and far-reaching. This article has provided a general overview of how private company stock options are affected by the statute.

Many private companies started down the road to Section 409A compliance years ago. Others have yet to embark on that journey or have stalled along the way. For those companies, the additional transition relief offered recently by the IRS should provide sufficient time to become 409A-compliant and fix "at-risk" options. For example, discounted NSOs that have not been exercised generally can be substituted with nondiscounted options (or otherwise made to be 409A-compliant) with no adverse tax consequences through December 31, 2008.

Private companies should consult with their tax advisors and legal counsel if they haven't already developed a plan for Section 409A compliance. And even if such a plan has been developed and implemented, companies should monitor their stock option plan documents and practices on an ongoing basis.

What will remain to be seen for some time is the manner and extent to which the IRS will enforce Section 409A. The IRS has announced that it will release information regarding a compliance resolution program in the coming year. Such a program, however, may provide relief for Section 409A violators only in limited circumstances.

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1. The final regulations can be found at: www.treasury.gov/press/releases/reports/td9321.pdf.
 2. Throughout Section 409A (and throughout this article) the terms "service provider" and "service recipient" are used. Service provider generally refers to the individual entitled to the deferred compensation (e.g., an employee, director or independent contractor). Service recipient generally refers to the company obligated to pay the deferred compensation.
 3. NQDC arrangements that were earned/vested on December 31, 2004 (under the terms of a NQDC plan in place as of October 3, 2004), are grandfathered and not subject to Section 409A. However, a grandfathered plan can be subject to Section 409A if the plan is "materially modified" after October 3, 2004.
 4. For instance, if the exercise price for an ISO is determined to be less than the grant date fair market value of the underlying stock, then it would be not be eligible for treatment as a statutory option. In addition, under certain circumstances the modification, extension or renewal of a statutory option will be treated as the grant of a new nonstatutory option subject to Section 409A.
 5. Section 422 of the Internal Revenue Code requires the exercise price of ISOs to be greater than or equal to the grant date fair market value of the stock subject to the option. This requirement is met if a good faith attempt is made to value the stock accurately, even if the good faith attempt resulted in a value less than fair market value.
 6. At Reg. § 1.409A-1(b)(5)(iv)(B)(1).
 7. At Reg. § 1.409A-1(b)(5)(iv)(B)(2).
 8. Issued in December 2004, Notice 2005-1 provided initial guidance under Section 409A and generally extended the compliance deadline to December 31, 2005.

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