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VIEWPOINT

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THE IRS ALTERS THE LANDSCAPE FOR DEFERRED COMPENSATION

By Bas van der Brugge

If you lead a private company, what you don't know about a new section of the Internal Revenue Code–Section 409A–may hurt you. Equally important, if you fail to meet the standards set up under these new regulations, you could cause major financial pain for the very employees you are trying hard to retain and reward.

Simply put, the IRS's new rules regulate a wide array of non-qualified deferred compensation arrangements, including most importantly, stock options. These regulations, among other things, establish new, more stringent standards for determining the fair market value (FMV) of stock options issued by private companies. The regulations were prompted by the perceived abuse of deferred compensation arrangements that came to light during recent corporate scandals, such as Worldcom, Tyco, and Enron, to name a few.

"This legislation was passed over a year ago, and the IRS did not issue substantive guidance on it until September, when the specific regulations came out," said Alexander Lifson, a Director of the Employee Benefits Group in the Boston office of Deloitte Tax LLP. "Executives at early stage and venture-backed companies are just now starting to open their eyes to how Section 409A is going to completely alter how nonpublic companies deal with their equity compensation programs."

Up to now, one of the chief ways start-ups and emerging growth companies could compete with larger, more financially robust businesses for top-notch talent was to issue stock options at "bargain rates." (Although the requirement for FMV for Incentive Stock Options has always existed, there was a great deal of leeway applied by most companies in the determination of what was their true FMV.)

Many prospective employees were willing to take less in current compensation in exchange for a potential big gain from the stock options if the company succeeded. The advent of Section 409A means that granting stock options at below true FMV is officially out the window as a tool for recruiting, retaining and incenting employees.

WHY THIS MATTERS:

- *You can no longer use undervalued (whether intentionally or accidentally undervalued) stock options or certain other forms of deferred compensation to attract or incentivize employees.*
- *Employees who receive stock options at below true fair market value now will be subject to hefty taxes and penalties. In turn, disgruntled employees might sue employers for reimbursement of their tax bills.*
- *Ignoring Section 409A may impact your ability to attract investors or buyers for your company because savvy investors and potential buyers have started to ask for assurances that companies are 409A compliant.*

Yet despite this potentially huge impact from Section 409A, Jonathan Levitt, founder and Principal of Outside GC LCC, which provides on-demand in-house legal counsel services to more than 100 start-up and emerging growth companies, agrees with Lifson that the issue is still not well-known enough among management. "But it's definitely on the radar screens of investors," Levitt commented. "In the last week I've attended two client Board meetings where the investors essentially refused to approve any option grants until the company had taken steps to ascertain a true fair market value for equity compensation."

THE NEW STANDARD

So how do you solve the problem? As stated in Section 409A, FMV must be determined by the use of "the reasonable application of a reasonable valuation method." If this standard is met, then the stock options will be exempt from the financial penalties prescribed by the new regulations.

But what exactly does the IRS consider an acceptable valuation method? Section 409A provides three solutions, which are referred to as "safe harbor" methods:

1. Illiquid Start-Up Presumption

This methodology applies to privately-held companies less than 10 years old (referred to in the statute as an "illiquid start-up"). A valuation of illiquid stock of a start-up must be in written form and will be considered reasonable if the valuation is performed by a person with significant knowledge and experience or training in performing similar valuations.

Also, the CEO must be able to specify whether the stock is subject to a put or call right and whether the company anticipates an IPO, sale or change in control within 12 months following the equity grant to which the valuation applies. CEOs who can't answer no to these questions must use another valuation methodology.

Finally, the valuation must take into account the value of tangible and intangible company assets, cash flows, control premiums, and discounts for lack of marketability of the stock, among others factors. A valuation applying these factors will be considered reasonable only if it is less than 12 months old.

2. Binding Formula Presumption

This valuation is based on the consistent application of a single formula used in all transactions in a company's stock whether or not compensatory, including (but not limited to) sales of stock to third parties, loan covenants, and regulatory filings.

3. Independent Appraisal Presumption

A valuation performed by a qualified independent appraiser using traditional appraisal methodologies will be presumed reasonable if it values the stock as of a date that is no more than 12 months before the applicable stock option grant date.

"Under 409A there is now an expectation that companies are going to go through a rigorous and defined valuation analysis to determine the stock value," said Lifson. "Companies can retain an outside appraisal firm or the valuation can be done with internal personnel or a related party, such as someone at a venture firm who sits on the board. But it still has to be done by people with the credentials and expertise to do it."

Be aware, however, that if you get into a battle with the IRS over Section 409A and you lose, the employees you are trying to reward will be hit with severe financial penalties. Income taxes on the difference between the discounted price and fair market value will kick in at the time of vesting rather than when options are exercised, as is currently the case. Also, a 20 percent excise tax will be assessed, along with any accrued interest if the taxes are being collected for prior tax years.

Companies that continue to grant discounted stock options will need to withhold payments for applicable income and employment taxes at the time of option vesting. Failure to do so may result in financial penalties for the company. Also, while the impact of Section 409A will probably not be as significant as that of Sarbanes-Oxley, it is very possible that investors and potential buyers will start asking for written assurances that a company is complying with these regulations as well as full indemnifications for failures to comply with 409A.

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> – Alexander Lifson of Deloitte Tax LLP

THINGS TO CONSIDER

As to giving advice about what is the best route for any specific

company, Alex Lifson said, "My main advice to clients is that if you're going to continue to grant stock options, you have to either have an outside appraisal expert or someone similar. You can't ignore this issue and continue to grant options as you have in the past."

"The nice thing about this regulation is that we're actually being told what to do," said Levitt. "A really simple road map for solving this problem is to hire an independent qualified valuation expert to do the FMV analysis."

If you choose to have an outside firm determine the FMV of your stock options, the best choice is to go with an organization that knows how to accurately value your type of company, both in terms of the specific industry and the business stage (for example, it is very difficult to value an early stage software company that has no revenues). Working with a firm that is in that marketplace and knows how to value such a business can be critical to obtaining a supporting valuation.

One note of caution is to be wary of firms that are jumping into the valuation business solely to take advantage of Section 409A-generated valuation opportunities (as occurred with the many Sarbanes-Oxley consultants that popped up a few years ago). Also, for private equity and VC investors who are considering bulk buying 409A valuations for their portfolio companies, this may not be the way to go for a variety of reasons (especially since each company and each valuation assignment is unique).

Another key item on your to-do list should be to consider adding some Section 409A language to your stock option plans. This language should inform employees about the risk around the FMV analysis and make them aware that the IRS could reassess the value of their options. The goal is to release your company of legal exposure if unhappy employees sue over unexpected tax bills.

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BURDEN OF PROOF

By consistently and reasonably applying one of the previously mentioned safe harbor methodologies to determine the FMV of your stock options, you shift the burden of proof on the IRS to prove that your valuation method is grossly unreasonable. On the other hand, if you fail to use one of the safe harbor methods, the burden of proof falls on you to show that the stock price you've set represents true and accurate FMV.

Clearly, if Section 409A is not part of your lexicon yet, it should be very soon. Although the new regulations have yet to be finalized, they will be effective for all unexercised option grants made after 10/3/04. The sooner you take action to deal with this brave new world of deferred compensation regulations, the better off your company and your employees will be.

(Author's Note: While this article has focused on stock options here, be aware that Section 409A covers other forms of deferred compensation, including stock appreciation rights, restricted shares, phantom stock, and other deferred compensation programs. So you will want to look at those portions of your compensation program as well to assure that they meet the new IRS standards.)

Bas van der Brugge, CFA *is a principal at Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and NASD/SIPC Member. For more information, visit www.merger.com.*

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