



AUTHORITATIVE — EXPERIENCED — EXPERT

January 2006

SECTION 409(A) AND ITS REGULATORY COUSINS: WHAT IT MEANS FOR PRIVATE COMPANIES – A COMMENTARY

The IRS recently “threw down the gauntlet” and placed pressure on private companies to get their valuations right – no matter what stage of development they are. The Service has backed up this gesture by exposing private companies to substantial tax liabilities and penalties if they don’t. Since the enactment of Section 409(A), non-public companies have struggled with how they should establish that the exercise price of a stock option or a stock appreciation right (SAR) was determined reasonably to be fair market value.

Up to this point most private companies did not worry about valuing their stock very often, if at all. Private company valuations were needed usually for an imminent transaction, for an ESOP, or for estate and gift tax purposes. One could also throw in serious IPO candidates who obtain a valuation to avoid a “cheap stock” issue with the SEC. Many private companies do not qualify for any of these scenarios; therefore they have not needed valuations in the past. As a result, companies and management that issue stock options could be somewhat unenthusiastic about this development. (Understandably so) However, although a valuation in this situation can appear fairly cumbersome and superfluous, it’s not all bad – just ask auditors.

Auditors have expressed a desire for this to be done for years. They are cognizant of this development because valuing stock options is a financial reporting issue under FAS 123 and they want to know how a private company established the strike price of its options. There is some liability risk attributed to auditors when they sign off on this standard, and a professional valuation provides them with a level of reasonableness and reassurance that they desire.

Considering this, there is a potential for tax and financial reporting synergy here. With a good valuation report on hand, both issues could be satisfied simultaneously – two birds with one stone if you will. First, let’s examine the code and regulations driving this change.



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SAY HELLO TO THE CULPRITS:

- **IRC Section 409A** requires private companies which award stock options that have exercise prices below fair market value to withhold income taxes on these grants. Significant penalties on non-complying option grants have placed private or closely held companies under increased pressure to be able to support and defend the fair market value determinations.
- **FASB 123**, Accounting for Stock-Based Compensation, provides alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation.
- **FASB 15X (Working Draft – issued October 21, 2005)**, Fair Value Measurements, established a framework for measuring fair value under a wide variety of accounting pronouncements that require fair value measurements. In developing FASB 15X, the Financial Accounting Standards Board considered the need for increased consistency and comparability in estimates of fair value and enhanced disclosures about the estimates.

REASONABLE, QUALIFIED, AND INDEPENDENT VALUATION TO THE RESCUE:

In most cases, when company management determines value and option pricing using an informal, internally generated valuation, the tax burden will be on the company to prove to the IRS that the fair market value of the equity is reasonable.

In light of the recent regulatory changes announced over the past year, many private companies are proactively adopting one of the “presumptive” stock valuation methods set forth in the proposed regulations. Procuring a qualified independent appraisal will cause the burden of proof to shift to the IRS and may only be rebutted by the IRS if the application of the method is found to be grossly unreasonable. Even better - it also can be used by auditors in FAS 123. Two birds with one stone.

ABOUT ERICKSON PARTNERS, LLC

Established in 2003 and based in Dallas, Texas, Erickson Partners, LLC is a professional corporation focused on business valuation, litigation support and valuation advisory services. The firm is headed by Don Erickson, a former tax partner and national director of business valuation for Ernst and Young, LLP. For more information please call (214) 468-8400 or visit our website at www.ericksonpartnersllc.com.