taxnotes federal

Volume 174, Number 10 ■ March 7, 2022

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Reprinted from *Tax Notes Federal*, March 7, 2022, p. 1357

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In this article, Tackney examines various aspects of the section 409A private corporation stock valuation regulations, and he explains why businesses may be tempted to adopt an overbroad reading of the rules.

For purposes of issuing awards under a stock option or stock appreciation right (SAR) program that qualifies for the regulatory exclusion for stock rights under section 409A, nonpublic corporations frequently obtain a stock valuation from an independent appraiser, often called a section 409A valuation. This process is intended to ensure that the exercise price of the stock option or SAR is no less than the fair market value of the stock on the date of grant, but as a valuation paid for by the corporation it may be enticing to use it for other purposes.

However, the section 409A regulations on the valuation of nonpublic stock address only the setting of the exercise price of a nonqualified stock option or stock appreciation right (collectively referred to as stock rights), and solely for purposes of determining whether the stock right qualifies for the exception from coverage under section 409A. Even regarding that limited purpose, the regulations create an issue of how long a section 409A valuation may be relied on and under what circumstances a new valuation may be required. Finally, a section 409A valuation typically arrives at the employer several weeks after the effective date of the valuation, creating a gap during which the employer is waiting for a valuation that will be retroactively effective. So merely having a section 409A valuation handy doesn't necessarily mean that it should be used.

The Exclusion From Section 409A

Section 409A sets forth rules governing nonqualified deferred compensation plans, with especially harsh rules if the plan fails to meet the requirements of section 409A, including an immediate income inclusion and additional income taxes. For purposes of applying section 409A, the regulations include stock rights as arrangements that may defer compensation. But based on the legislative history, the regulations also provide for an exception if the stock right meets specific requirements.

Reg. section 1.409A-1(b)(5) sets forth the exclusion from coverage under section 409A for stock rights. Statutory stock options, meaning incentive stock options under section 422 and qualified employee stock purchase plans under section 423, are excluded. For nonstatutory stock options and SARs, reg. section 1.409A-1(b)(5)(i)(A)(*1*) and (b)(5)(i)(B)(*2*) require, respectively, as part of the exclusion that the exercise price of the stock option or the SAR be no less than the FMV of the underlying stock on the date of grant.

Reg. section 1.409A-1(b)(5)(iv) then sets forth the valuation rules for determining whether that requirement is met. For corporations the stock of which is publicly traded, meaning regularly traded on an established securities market, reg. section 1.409A-1(b)(5)(iv)(A) provides a series of approved valuation methods all based on the reported trading prices. While there is some debate on when a stock is publicly traded, the more intriguing issues arise under the rules governing the valuation of stock that isn't publicly traded.

Valuation Rules for Nonpublicly Traded Stock

Reg. section 1.409A-1(b)(5)(iv)(B) provides the valuation rules for stock that isn't publicly traded. As a general rule, it provides that "the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method." It further provides that whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is determined based on the facts and circumstances as of the valuation date. Note that the rule applies not to the number calculated, but to the two-part process — first, whether the valuation method selected is reasonable in the context of that specific stock, and second, whether that method has been reasonably applied to the relevant facts and circumstances. Regarding when such an appraisal must be obtained, the regulations provide that:

> the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used.

As reflected in the preamble to the final regulations, given the harsh consequences of failure, commentators to the proposed regulations expressed great anxiety that a valuation would be questioned as unreasonable, including regarding a relatively minor reduction from what the IRS would find to be a threshold reasonable value. In response, the regulations provide a presumption that the use of specific methods of valuation results in a reasonable valuation, and that the Commissioner may rebut such a presumption only upon a showing that either the valuation method or the application of such method was grossly unreasonable.

The first presumption is for:

> a valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).[1]

That provision is often referred to as a safe harbor, although it is only a rebuttable presumption. The reference to section 401(a)(28)(C) sets forth requirements for the valuation to be conducted by an independent appraiser, and this use of an independent appraiser to assure the rebuttable presumption of reasonableness often is labeled as resulting in a section 409A valuation.

Period of Reliance on a Section 409A Valuation

One question that arises repeatedly is how the 12-month period for the presumption relates to the general requirement that use of a valuation is no longer reasonable once there is new information that could materially affect the stock's value. This arises when there has been a marked increase in the stock's value, either perceived or even demonstrated, such as through a valuation conducted for a different purpose or a tentative or definitive price being set as part of a future transaction with a third party. Some have argued that the presumption section should be read independently, meaning that regardless of subsequent events the section 409A valuation remains viable for 12 months.

But the presumption relates only to whether the use of a method of valuation results in a reasonable valuation and can be rebutted by showing that either the method or the application of the method was grossly unreasonable. Arguably, the presumption applies only to the reasonableness of the valuation method and the application of that method to calculate a value (that is, the validity of the valuation as of its effective date) — topics that the IRS may address to rebut the presumption, which may be different than the reasonableness of the continued use of the calculated value.

[1] *See* reg. section 1.409A-1(b)(5).

But whether read in context with the general rule or strictly as an independent presumption, a position that a section 409A valuation remains viable for 12 months regardless of any subsequent events seems inconsistent with the regulatory provision. The presumption provision isn't a safe harbor, but rather a presumption that can be rebutted if either the valuation method or the application of that method were grossly unreasonable.

If a separate valuation, or a third-party valuation as part of an arm's-length transaction, has assigned the shares a significantly higher value, it may be a grossly unreasonable application of the valuation method to use the prior section 409A valuation in determining whether the stock right exclusion is met for subsequent grants. Even without these competing valuations, the types of events named as ending reasonable reliance on a prior valuation under the general rule — the resolution of litigation or the issuance of a patent — would have such an effect on the value of the stock that it likely would render the use of the prior valuation grossly unreasonable.

In other words, if it is generally understood that subsequent events caused the value of the stock to be several times higher than the value reflected in a prior section 409A valuation, the presumption appears rebutted and changes the question to, "How is it not grossly unreasonable to use that prior valuation?" How is this not grossly unreasonable if significantly higher valuations are being used for other nontax purposes such as loans and credit facilities or other corporate transactions requiring a stock valuation? In those situations, an argument that values can always change, or other similarly unquantifiable arguments, may fall short.

Although the financial accounting aspects of the use of a section 409A valuation to establish an exercise price is beyond the scope of this article, similar issues have arisen in that area. Accounting Standards Update 2021-07[2] addresses the use of section 409A valuations, including a finding that for the use of a previously calculated value to be considered reasonable, the value must be updated for any information available after the date of calculation that may materially affect the value of the entity. Thus, the consideration of the use or continued use of a section 409A valuation should take into account not only the federal tax consequences but also the financial accounting consequences.

Period From Effective Date to Delivery

The general ability (absent a significant corporate event) to use a section 409A valuation for 12 months creates the potential for a 12-month valuation cycle. But the valuation process itself creates timing issues given that the effective date of a valuation typically is several weeks before the valuation is received. It is unclear whether a prior section 409A valuation may be relied on during this interim period, given that the relevant grant date would be after the effective date of the new valuation.

For example, assume an employer receives a valuation every year with an effective date of July 1 and a final delivery date of August 15. If the employer grants a stock option on August 1 with an exercise price based on the existing section 409A valuation, it won't be eligible for the presumption because the grant date will be more than 12 months beyond the valuation's effective date.

One idea would be to have a new section 409A valuation with an effective date of May 1, which would be delivered on or before July 1 so that there would be no gap. But that raises the issue of whether the existing section 409A valuation may be used in the interim period between the effective date and the receipt date of the new section 409A valuation. For example, if a stock option is granted on June 1 using the existing section 409A valuation and the new section 409A valuation received on July 1 has a higher valuation effective as of the prior May 1, that new valuation reflecting appreciation would mean that the June 1 grant had an exercise price below FMV on the date of grant.

Is it grossly unreasonable to use the prior valuation while waiting for a new valuation that will provide a retroactive valuation covering the grant date? Perhaps not if it is anticipated that the new section 409A valuation will be within a range of the existing section 409A valuation, reflecting

[2] ASU 2021-07, "Compensation-Stock Compensation (Topic 718)" (Oct. 2021).

that all valuations are in some respect one number within a range of estimates. But when the new section 409A valuation is anticipated to be (and is) significantly higher, that will raise the issue of whether the existing section 409A valuation may be relied on at all, much less during a period that will be covered by a new section 409A valuation explicitly evidencing that significantly higher valuation.

This timing issue often arises if it is determined that corporate events have occurred necessitating an off-cycle section 409A valuation because the impetus for that analysis typically is a desire to make new stock right grants. In that case, what valuation should be used for any grants in the interim period before the receipt of the new section 409A valuation? And does the interim period start as of the effective date of the new valuation or the date at which it was determined that a new valuation was needed?

One answer is simply to avoid grants during this interim period and wait for the new section 409A valuation to arrive. But that may raise issues if there are previously scheduled grants or policies of granting options to new employees and the grant dates fall within this interim period. The section 409A corrections program permits a no-harm, no-foul reset of the stock option exercise price in the same year as the grant to reflect an exercise price that is below FMV on the date of grant (and in the following year for recipients that are not insiders).[3] But this would require consideration of how to communicate the potential increase in exercise price to the recipients of the stock options, the burden of which may outweigh that of waiting to receive the new section 409A valuation, including restructuring stock option programs to accommodate valuation cycles.

It is generally a best practice to work closely with valuation teams well in advance of anticipated annual or other routine grant dates to get ahead of any perceived or anticipated issues with the timing and application of valuations.

Determining the Exercise Price

The section 409A valuation rules technically don't apply for purposes of section 422(b)(4) and the requirement that for an option to qualify as an incentive stock option (ISO), the exercise price must equal or exceed the FMV at grant of the underlying stock.[4] Reg. section 1.422-2(e)(1) provides that for this purpose, "the option price may be determined in any reasonable manner, including the valuation methods permitted under section 20.2031-2 of this chapter, so long as the minimum price possible under the terms of the option is not less than the fair market value of the stock on the date of grant." Note that although reg. section 20.2031-2 provides guidance regarding the factors that may inform the valuation of stock that isn't publicly traded, it doesn't address the length of time for which the valuation may be relied on, or the frequency with which valuations must occur.

However, the valuation requirements in sections 409A and 422 are intended to serve the same purpose of ensuring that any compensation received from the stock option results from post-grant appreciation in the underlying stock, and therefore the section 409A valuation rules should be found to be a reasonable manner of determining FMV, including the presumption that a valuation continues to be reasonable for a 12-month period from its effective date.

Arguably, the same need for a nonpublic corporation to have confidence that its options aren't subject to section 409A exists regarding whether its options qualify as ISOs, given that it must communicate the federal tax consequences to the employees granted the ISOs as well as be prepared to track subsequent sales resulting in nonqualifying dispositions that the employer will be responsible for reporting. Also, any failure of the stock option to qualify as an ISO would then require an analysis of whether that same stock option qualified for the exception from nonqualified deferred compensation in the section 409A regulations. It would be awkward for one valuation regime to be applied to determine that the ISO valuation requirement

[3] *See* Notice 2008-113, 2008-51 IRB 1305, sections IV.D and V.E.

[4] *See* reg. section 1.422-2(a)(2)(iv) and (e)(1); *see also* reg. section 1.421-1(e)(2).

hadn't been met, while a separate valuation regime is applied to determine that the section 409A valuation requirement had been met. For these reasons, many are hopeful that the IRS will apply these two valuation requirements consistently, and taxpayers generally have taken this approach.

Section 83 and Employment Taxes

The use of a section 409A valuation for purposes of setting a FMV exercise price of a stock right is difficult to extend to the valuation of the stock for purposes of determining the compensation income under section 83 and the accompanying wage payment for purposes of the FICA tax. The section 409A regulatory valuation rules regarding the exercise price at the time of the stock right grant don't apply for purposes of determining income under section 83 or wages for purposes of federal employment taxes, both of which are determined at the time of exercise of a stock option or stock-delivered SAR (or, if the stock received upon exercise is substantially nonvested, at the earlier of vesting or the time any section 83(b) election is made).

So for purposes of determining the amount of compensation income and wages at exercise, there is no regulatory argument that deference should be given to a prior section 409A valuation. While the reporting of the compensation income and wages generally may wait until the following January, the related employment tax withholding and deposits generally must occur contemporaneously (or nearly contemporaneously) with the exercise.

That is problematic when some event requiring valuation occurs fairly soon after the date of exercise, and even more problematic if that event had already been scheduled at the time of exercise. For example, if a liquidation event or a recapitalization event occurs within weeks of a stock option exercise and displays an arm's-length valuation significantly higher than a prior section 409A valuation used for purposes of applying employment taxes, it may be difficult to explain how the significant increase in value occurred only after the exercise date. It will be that much more difficult if the corporate event had already been scheduled when the exercise occurred.

Even if there has been no significant corporate event that could affect valuation, the reliance on a previous section 409A valuation will create timing issues for exercises occurring after the effective date of the next grant cycle's valuation but before that valuation has been received. For example, if a section 409A valuation is requested to be effective every April 1 but the valuation generally isn't finalized and received by the corporation until May 15, the new valuation won't be available at the time of exercise for stock option exercises occurring between April 1 and May 15.

However, reliance on the prior valuation would seem inappropriate for withholding purposes given that the corporation will have a new valuation effective as of the date of exercise. If the stock has depreciated, this may raise less significant overwithholding issues that may be handled through the adjustment processes for employment taxes; but if, as is (hopefully) more common, the stock has appreciated, there may be more significant issues with underwithholding. As with any underwithholding, the issues are not insurmountable but may be costly both in administrative burden and potential deposit penalties, as well as raising potential employee relations issues when the additional makeup withholding is applied.

Conclusion

The section 409A valuation regulations were intended to provide an ongoing private business an opportunity to rely on an annual process of requesting stock valuations, rather than a separate valuation for each grant, as a way of reducing the cost of compliance for ongoing stock right programs. Now that businesses have grown accustomed to having these valuations in hand, it has become tempting to use them for an entire year regardless of intervening circumstances and for purposes unrelated to the application of the section 409A stock right exclusion.

Unfortunately, that appears to be an overbroad reading of the regulatory structure that may be subject to challenge, especially when on the date the section 409A valuation is used there is (or will be) another significantly higher valuation available, or when there is a corporate transaction in the future that is reasonably anticipated to reflect a significantly higher valuation. In essence, good news regarding significant appreciation in equity value may trigger the need for a new valuation, and taxpayers would be wise to consider this before engaging in any transactions (grants, exercises, section 83(b) elections, or vesting dates) when a valuation may be needed.[5] ■

[5]The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

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