

New Section 409A Requirements for Private Companies: Navigating through Traps for the Unwary

**Speaker: Matt Henson, Esq.
Partner
Henson Parker Vyadro, P.C.
Boston, MA**

November 30, 2006
Copyright © 2006 by Matthew Henson
mhenson@hpvpc.com
617-367-1800

■ ■ ■ ■
HENSHON PARKER VYADRO, P.C.

Overview



Background

- I. General rule/Key Concepts (§409A)
- II. Specific Issues
 - A. Bonuses
 - B. Severance
 - C. Private Cos. And Valuation
- III. Thoughts: Governance and Conflict Issues

Background

- Corporation lawyer must be aware of the impact of §409A
- Tax law concepts
- Private company: valuation more of an issue
- Analogy: §83(b) election

§409A - Key Dates

- October 11, 2004: Congress passes American Jobs Creation Act
- October 22, 2004: President Bush signed Act (Public Law 108-357, 118 Stat. 1418)
- Nominal effective date: January 1, 2005
- December 2004: Notice 2005-1 published (2005-2 I.R.B. 274)
- September 2005: Proposed Regulations published
- December 2005: Notice 2005-94
- October 2006: Notice 2006-79

“New” Effective Date

- Original Date: January 1, 2005
- Proposed Regs: September 29, 2005, theoretically applicable for 2005
- December 8, 2005: no withholding and reporting for 2005 at this time, although taxpayers must comply with “future published guidance” (IRS Notice 2005-94)
- Final regs expected “Late 2006”
- Notice 2006-79: “Additional Transition Relief”

Reporting Requirement

- W-2
- 1099
- Shows both amounts current and amounts “properly” deferred in the future

2006 1099 Form

VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Rents	OMB No. 1545-0115		Miscellaneous Income
		\$	2006	Form 1099-MISC	
		2 Royalties			
PAYER'S federal identification number		\$	4 Federal income tax withheld	\$	Copy 1 For State Tax Department
		3 Other income	5 Fishing boat proceeds	6 Medical and health care payments	
RECIPIENT'S identification number		\$	7 Nonemployee compensation	8 Substitute payments in lieu of dividends or interest	
RECIPIENT'S name		\$	9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	10 Crop insurance proceeds	
Street address (including apt. no.)			11	12	
City, state, and ZIP code			13 Excess golden parachute payments	14 Gross proceeds paid to an attorney	
Account number (see instructions)		\$	15a Section 409A deferrals	15b Section 409A income	16 State tax withheld
		\$			17 State/Payer's state no.
		\$			18 State income
		\$			\$

Form 1099-MISC

Department of the Treasury - Internal Revenue Service

Part I

- General rule/Key Concepts (§409A)

Key Concepts of IRC §409A

- Amounts deferred
- Under a nonqualified deferred compensation plan (“NQDC”)
- Are currently includible in gross income
- To the extent that they are not subject to a substantial risk of forfeiture; and
- Not previously included in gross income

What is a “plan”?

- A plan is “any agreement, or arrangement”
- Company-wide
- Or, can apply only to one person or individual
- May be adopted “unilaterally” or may be negotiated amount or agreed to by the service recipient(s) (or their representatives)

What's a “non-qualified deferred compensation” plan?

- Any plan that provides for deferral of compensation
- Exceptions: qualified retirement plans (e.g., 401(k)); tax-deferred annuities; simplified employee pensions (e.g., SEP-IRAs); SIMPLEs; §501(c)(18) trusts
- Qualified ISOs
- Also exempt: ‘bona fide’ vacation leave; sick leave; ‘comp time’; disability pay
- Special concern: Medical plans
 - Archer Medical Savings Accounts
 - Health Savings Accounts
 - Esp.: Severance agreements

“Deferral”

- Service provider (i.e., employee)
- Has legally binding right
- To compensation that has not been actually or constructively received and included in gross income, and
- Is payable to (or on behalf of) the service provider in a later year

“Substantial Risk of Forfeiture”

- Discretion
- Any ‘additional risk’ items – whether elected by service provider (employee), service recipient (company), or others are disregarded
- Non-compete payments (payments “refrain from providing services”) do not entail ‘risk of forfeiture’

Enforcement of “Forfeiture”

- Whether risk of forfeiture is substantial, will look to whether service recipient (company) will actually enforce
- Control of service recipient (company)
 - Service provider as stockholder
 - Service provider as director
- “Past Performance not indicative of future results...”

Failure to meet §409A requirements

- At any time, if a plan fails to meet requirements
- Amounts in question are includable in plan participant's (i.e., employee) gross income for taxable year
- To the extent not previously included
- Note: Notice 2006-79 adds individualized concept for participant(s):
 - “an exercise of a right under the terms of the plan by a participant solely with respect to that participant's benefits under the plan, in a manner that causes the plan to fail to meet the requirements of section 409A, will not be considered to result in the plan failing to be operated in good faith compliance with respect to other participants.”

Or else...

- Underpayment interest rate
- Current rate = 8% (4th quarter 2006) (Rev. Rul. 2006-49)
- Plus one (1%) = 9%
- **PLUS**, 20% penalty of the compensation otherwise required to be included in gross income
- Individual, not corporate, obligation, but...

Part II: A

- Bonuses

Special Treatment for Bonuses

- Exception from §409A for an annual bonus (or the like) paid within 2 ½ months after close of taxable year.
- Can also include involuntary separation pay
- A.k.a. “2-1/2 month rule”

Part II: B

- Severance

Severance

- Problems if:
 - (a) (i) more than 2x employees annual compensation; or
 - (ii) more than \$420,000 (2005) or \$440,000 (2006), and
 - (b) such separation pay (even if under limits) must be paid not later than December 31 of second calendar year following calendar year in which the separation takes place
- Contrast with 2 ½ month rule
- Non-compete does not serve as “consideration”

Part II: C

- Stock Options and Valuation

Private Companies

- Most relevant non qualified deferred compensation plan: Options
- How to value options?
- Private cos. have multiple issues to consider:
 - Are we going to raise another round?
 - What's the exit: sale or IPO?

Private Company Valuations

- Option price = “Fair Market Value”
- Notice 2005-1 (January 2005): “Any reasonable valuation method may be used”
- Reasonably and consistently applied
- In response for “more guidance”, IRS addressed in Proposed Regs

Private Company Valuations 2

- Is there an established market for stock (public sales)?
- If not, proposed regs state that as long as a “method is applied reasonably and used consistently, the valuation determined by applying such method will be presume to equal the fair market value of the stock”
- “Rebuttable only by a showing that valuation is grossly unreasonable.”

Private Company Valuations 3

- Factors in “reasonably” valuing companies as per §409A proposed regulations:
 - Value of tangible and intangible assets
 - Present value of future cash flows
 - Market value of stock engaged in substantially similar trades or businesses
 - Control premium/discount for illiquidity
 - Consistency
 - “All material information”

Private Company Valuations 4

- What's not included in proposed regs?
- Pre-revenue / pre-profit start-ups
- Safe Harbors
 - Start-up written report
 - Third party appraisal
 - Formula

Valuing “start-up” private companies

- “Start-up” = less than 10 years of trade of business
- Valuation of an illiquid stock presumed to be reasonable if made reasonably and in good faith and evidenced by a written report taking in account factors for valuations generally under proposed regulations.

Valuation – Not exact science

- Asset (liquidation, replacement costs)
- Income (discounted cash flows, etc)
- Markets (analogies to public companies, M&A transactions)
- Company specific (cap structure, other events)
- “All material information”

“Written report” safe harbor

- Test: “made in good faith by person with significant knowledge and experience or training in performing similar valuations”
- Probably done by a board member (venture capitalist or ‘angel investor’), referencing the factors cited by the IRS
- Liability/insurance disclaimer?

Third-party appraisal safe harbor

- Third-party appraisal: another option
- Same test: “made in good faith by person with significant knowledge and experience or training in performing similar valuations”
- Costs are unknown
- 12 –month look-ahead (commencing on the date appraisal values stock

BUT, what about IPOs or other sales?

- “Reasonable” valuation safe harbors do not apply where employee or Company “may reasonably anticipate, as of the time the valuation was applied, that the [Company] will undergo a **change in control event** or participate in a **public offering** of securities within **12 months**...”
- 20/20 hindsight
- 12-18 months of “runway”
- Planning: FASB, SEC oversight

Part III

- Thoughts: Governance and Conflict Issues

Advising the CEO/Officer

- Wants to add staff with option pool
- Costs of adding first employee of a given 12-month period are high (must get third-party appraisal or proper 'written report')
- 12-month window: likely timeline to raise more \$/sell company
- Hiring dates?

Advising the Angel Investor/Director

- Are you qualified? (A “person with significant knowledge and experience or training in performing similar valuations”)
- “In good faith”?
- Covered by D&O insurance?
- Costs

Advising the Venture Capitalist/Director

- Presumably qualified
- “In good faith”?
- Personal exposure?
- Written report? (Same valuation you are reporting to limited partners?)
- Third-party appraiser: consistent valuation results across all portfolio companies?

Advising the Employee

- Ask for '§409A compliance'
- Indemnification from Employer for failure? (20% penalty plus 1%+underpayment rate)
- By the way, no cash to pay tax
- Watch out for: severance payments.

Other ideas

- “Founders Stock”
- IRS Commissioner Everson (3/14/2006):
 - “I wonder whether tax compliance, let alone corporate and shareholder interests, would not be better served if CFOs, general counsels, and nonexecutive board chairs received generous but fixed compensation for specified contract periods. Were boards to move to this model, it would reinforce sound, conservative, fiduciary stewardship.”
 - I.e., Do not receive options
 - Context: Public companies
- Partnership regs

Notice 2006-79

- Extend out to January 1, 2008
- Act “in good faith” with existing guidance
- But no extension for certain discounted stock rights (either stock option or stock appreciation right (SAR)) (Section 3.07):
 - (A) was granted with respect to stock of a corporation that as of the date of grant had issued any class of common equity required to be registered under Section 12 of 1934 Act;
 - (B) was granted to any person who, as of the date of the grant, was subject to the disclosure requirements of Section 16(a) of the 1934 Act; and
 - (C) with respect to the grant of such stock right, such corporation either has reported or reasonably expects to report a financial expense due to the issuance of a stock right with an exercise price lower than the fair market value of the underlying stock at the date of the grant that was not timely reported on financial statements or reports for the period in which the related expense should have been reported under GAAP.

Conclusion

- 2006 or 2007 actions may have consequences next April 15th

Resources

- Notice 2005-1: http://www.irs.gov/irb/2005-02_IRB/ar13.html
- Proposed Regs: <http://www.ustreas.gov/press/releases/reports/reg15808004.pdf>
- Notice 2006-79: http://www.irs.gov/irb/2006-43_IRB/ar09.html