



IMPORTANCE OF ADHERING TO 409A REGULATIONS TO AVOID PENALTIES AND EXCISE TAXES

Abstract

IRC 409A offers a robust governance framework for nonqualified deferred compensation plans. Compliance with 409A valuation guidelines ensures a “safe harbour” status, establishing transparency and trust among stakeholders and investors. Companies can avoid common 409A errors – stock value miscalculations or options mismanagement – by ensuring proper documentation, regular valuation assessments, and partnership with a reputed valuation provider. With the right solutions for 409A retirement plans, you can achieve compliance, mitigate risks, and maintain a competitive edge in attracting top talent.



As the global race to attract and retain top talent becomes intense, companies are offering attractive compensation packages to stand out. This includes nonqualified deferred compensation plans and stock options that can grow tax deferred. Although they are great tools to attract and retain talent, these plans come with a host of challenges, especially when it comes to 409A valuation and 409A penalties associated with non-compliance.

Before the IRA established the Internal Revenue Code (IRC) 409A, privately held companies had no rule of thumb, guidelines, or framework to validate their stock options or ensure Fair Market Value (FMV) accuracy. However, the Enron scandal in 2001, where the company was inflating its income and hiding losses through deceitful accounting practices to spike stock prices, uncovered critical flaws in the US corporate and regulatory

ecosystem. This led to a paradigm shift in stock options valuation, governance, and corporate financial reporting, resulting in the introduction of Internal Revenue Section 409A under the American Jobs Creation Act of 2004. To address the critical gaps in tax-deferred compensation laws, 409A established a robust framework for governance, ensuring transparency, regulation, and preventing future fraud.

Understanding IRC 409A valuation and compliance

IRC 409A governs the nonqualified deferred compensation plans US-based companies offer, setting rules and governance frameworks to ensure company executives cannot use these plans to defer tax unfairly. Under this framework, 409A valuation involves independent appraisal of the FMV of the company's common stock, which then becomes a benchmark for the stock price of stock options employees receive

as a part of their nonqualified deferred compensation plan.

The key aspects of 409A valuation include transparency and regulation, safe harbour provisions, and material events considerations, and non-compliance results in 409A tax penalties. Material events refer to any significant events that may change the company's valuation, including financial rounds, mergers and acquisitions,

major business model changes, or major market disruptions.

Companies typically rely on third-party 409A valuation providers and solutions for 409A retirement plans to determine this valuation, which is valid for twelve months. Companies need to get a 409A valuation before they start offering stock options to their employees and repeat it annually unless a material event breaks the cycle.

Common 409A valuation methodologies

Taking anywhere between ten days and one month – depending on the 409A valuation provider – the complete 409A valuation process involves the following steps:

- Initial consultation and data collection
- Valuation modelling and analysis
- In-depth review and valuation preparation
- Draft report review and feedback
- Finalised 409A valuation report

The goal of this process is to ensure a “fair” FMV evaluation to ensure the company can achieve the “safe harbour” status and avoid 409A penalties. The three standard methodologies independent appraisers use to establish 409A valuation include:

Market approach

When a company is raising new funding, valuation experts often rely on the Option Pricing Model (OPM) back-solve method and assume that the share price

new investors have paid is fair. However, investors usually get preferred stock, so adjusting for the FMV of common stock is necessary.

Another market approach method involves estimating your company’s equity value by comparing financial information — net income, revenue, and EBITDA (earnings before interest, taxes, depreciation, and amortisation) — to comparable public companies.

Income approach

For businesses that have established revenue and cash flow, a simple income approach can help determine a company’s value based on the expected future cash flows, adjusting the income and cash flow for risk.

Asset approach

The asset approach is best suited for establishing an FMV common stock valuation for companies in the early stages – who have not raised any funding

or generated revenue. This methodology accounts for the company’s net asset value for valuation modelling.

Some of the typical information and documentation an independent 409A valuation provider needs include:

- Company details, including the details of relevant stakeholders and articles of incorporation
- Industry details, including names of comparable public companies
- Funding and options details, including business plan, company presentation, and estimated timing of liquidity events
- Company financial details, including past financial statements, revenue forecast, EBITDA forecast, debt, and more
- Any additional details or relevant material events since the last 409A valuation



Legal requirements for achieving 409A “safe harbour” status

Ensuring FMV evaluation and achieving a “safe harbour” status is crucial for companies offering nonqualified deferred compensation plans to avoid 409A tax penalties. Achieving a safe harbour status means that the IRS considers your valuation valid and defensible, shifting the burden of proof to the IRS if they want to challenge the fair market evaluation of your company’s common stock price.

Every company completing the 409A valuation process to achieve this status must adhere to the five legal requirements, which are:

- The incentive equity a company offers its employees must be based on a written 409A valuation assessment report.
- The company must update its 409A valuation every twelve months.

- If any material events occur before valuation expiry (12 months), the company must update its valuation.
- The company must use a third-party independent specialist to perform 409A valuation.

The company must use a “reasonable” valuation method, accounting for all the available information and applying it consistently to ensure accurate FMV evaluation.

Common 409A errors and penalties

Ensuring 409A valuation compliance can be complex, requiring keen consideration of several factors to ensure an FMV of the company's common stock. Many common errors, including incorrect calculation, early or late payments of the amount payable, or failure to adhere to 409A definitions for specified terms, can lead to non-compliance and 409A penalties.

Some of the common 409A compliance pitfalls companies must avoid include:

- **Miscalculating common stock value:** Many companies make the mistake of aiming for the lowest possible stock value to receive cheap stock options. This can result in significant compliance issues and legal and financial representations.
- **Improper options management:** Granting the stock options at less than the FMV or mismanaging the grant timing can also cause non-compliance issues, resulting in a 409A tax penalty.
- **"Safe harbour" methodology non-compliance:** Deviation from accepted valuation methodologies, like working

with an independent appraiser, can have severe consequences.

- **Lack of documentation:** Exhaustive recordkeeping is crucial for 409A compliance. Lack of (or inadequate) documentation regarding the valuation process (data collection, modelling, and analysis) can create issues during audits.
- **Disregarding material events:** Failing to account for material events and reassessing 409A valuation can result in outdated and unacceptable valuations, removing the "safe harbour" status.
- **Use of inappropriate historical data:** Using outdated, incomplete, or incorrect historical data can not only result in incorrect valuation but also pose critical compliance challenges.
- **Failure to reassess valuation regularly:** Failure to ensure regular valuation reassessment—annually or after material events—will result in non-compliance with the IRS guidelines.

In an unfortunate case where a company becomes vulnerable to any of these pitfalls, it can face serious consequences and 409A

penalties, including:

- Immediate income recognition of all the deferred compensation (bonuses, stock options, and more) from the year the error occurs. These amounts will add to the employee's gross income for the year, and the employee will be responsible for paying the tax.
- An additional 20% penalty tax on taxable income.
- Need to restate and refile previous years' tax forms by employees and companies.
- Additional penalties and interest on late payments due to additional income recognition.
- Potential for additional state-imposed penalties and legal consequences.

Although the employee is responsible for paying the taxes, the company also has to report the deferred compensation properly. Failure to do so can expose the company to 409A penalties. Additionally, this can also jeopardise the company's reputation among potential investors and top talent, leaving the company vulnerable to massive liability.



409A correction program

The IRS has a 409A correction program that can help companies minimise or eliminate some of the 409A tax penalties. However, the company has to identify and correct the error and notify the IRS

within two calendar years following the error. Companies can often correct these errors by resetting the stock price to the appropriate amount. However, the longer you wait to correct the error,

the more penalties you will have to face. Additionally, if the employee cannot repay the payment constituting the error, it will not be eligible for correction.

How to avoid the 409A tax penalty?

Relying on the 409A correction program may not be the best strategy to avoid 409A penalties, as each correction comes at a price. Here are some things you can do to get 409A valuation and compliance right the first time:

- Ensure up-to-date, complete, and accurate documentation at every stage.
- Review your nonqualified deferred compensation plans regularly to ensure you are not missing any crucial details that may contribute to non-compliance.
- Conduct regular 409A valuation to ensure validity and “safe harbour” status.
- Be mindful of any material events that might impact company valuation to ensure up-to-date 409A valuation.
- Work with a reputed valuation

provider or invest in solutions for 409A retirement plans to ensure accurate valuation and guarantee a “safe harbour” status. When choosing the right 409A valuation provider for your business, consider aspects like competitive costs, quality of service, and valuation compliance.

Conclusion

Understanding and adhering to IRC 409A guidelines is crucial for companies using nonqualified deferred compensation plans as tools to attract and retain top talent. Ensuring accurate and frequent 409A evaluation is key to not only avoiding 409A penalties but enhancing transparency

and trust among stakeholders and investors as well. Maintaining proper documentation, regular review of compensation plans, frequent valuation assessments, and working with reputed valuation providers are key to avoiding 409A errors and minimising penalties.

By implementing effective [solutions for 409A retirement plans](#), companies can maintain compliance and achieve the “safe harbour” status, thereby mitigating the risk of costly penalties and maintaining their competitive edge in attracting top talent.

For more information, contact infosysbpm@infosys.com

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