



Services

[Employee Benefits and Executive Compensation](#)

[Fiduciary Duties and Governance](#)

[Qualified Retirement Plans](#)

[Taft-Hartley Plans](#)

[Health and Welfare Plans](#)

[Government Plans](#)

[Higher Education](#)

[Employee Stock Ownership Programs \(ESOPs\)](#)

[Executive Compensation and Nonqualified Plans](#)

[ERISA and Benefits Litigation](#)

[College Savings and ABLE Plans](#)

[Mandatory Paid and Unpaid Leave](#)

[Audits and Investigations](#)

Getting the 409A Valuation Right for Stock Rights

Section 409A of the Internal Revenue Code (“Section 409A”) regulates the taxation of nonqualified deferred compensation, including stock options and stock appreciation rights (“Stock Rights”). In particular, a Stock Right granted with an exercise price that is less than the grant date fair market value is considered deferred compensation subject to Section 409A; such a Stock Right, if designed to give the holder discretion over the exercise date, would likely violate Section 409A and result in significant penalties on the holder. Accordingly, it is important for employers to grant Stock Rights at fair market value in order to exempt them from being deemed deferred compensation under Section 409A.

Section 409A specifically outlines acceptable methods for determining the fair market value of stock that is readily tradable on an established securities market. Such methods include the last sale price before the grant, the first sale price after the grant, the closing price on the trading day before the grant, the closing price on the trading day of the grant, the mean of the high and low prices on the trading day before the grant, and the mean of the high and low prices on the trading day of the grant.

With respect to stock not readily tradable on an established securities market, Section 409A sets forth three valuation safe harbors:

1. **Qualified Independent Appraiser Method.** A valuation is presumed reasonable if it is determined by a qualified independent appraiser no more than 12 months before the grant date.
2. **Illiquid Startup Method.** A valuation of a company that has conducted business for 10 years or less and is not reasonably expected to imminently undergo a change in control or a public offering is presumed reasonable if: (a) the valuation was performed within the past 12 months by a person with significant knowledge and experience or training in performing similar valuations; (b) the valuation is evidenced by a written report; and (c) the valuation considers the reasonableness factors identified above.
3. **Non-Lapse Restriction Method.** A valuation is presumed reasonable if it is based on a permanent transfer restriction that requires the transferee to sell the stock at a formula price (e.g., book value or a reasonable multiple of earnings) and such valuation is consistently used for both compensatory and non-compensatory purposes in all transactions in which the issuer is either the purchaser or seller of the stock.

Contacts

John E. Schembari

Omaha
402.231.8886
john.schembari@kutakrock.com

Michelle M. Ueding

Omaha
402.661.8613
michelle.ueding@kutakrock.com

William C. McCartney

Irvine
949.852.5052
william.mccartney@kutakrock.com

P. Brian Bartels

Omaha
402.231.8897
brian.bartels@kutakrock.com

Cindy L. Davis

Minneapolis
612.334.5000
cindy.davis@kutakrock.com

Ruth Marcott

Minneapolis
612.334.5044
ruth.marcott@kutakrock.com

Jeffrey J. McGuire

Omaha
402.661.8647
jeffrey.mcguire@kutakrock.com

Sevawn Foster Holt

Little Rock
501.975.3120
sevawn.holt@kutakrock.com

John J. Westerhaus

Omaha
402.231.8830
john.westerhaus@kutakrock.com

Emily P. Dowdle

Omaha
402.661.8683
emily.dowdle@kutakrock.com

Robert J. Hannah

Omaha
402.661.8667
robert.hannah@kutakrock.com

Rachel A. Loscheider

Minneapolis
612.334.5011
rachel.loscheider@kutakrock.com

Emma L. Franklin

Omaha
402.231.8842
emma.franklin@kutakrock.com

Use of one of these safe harbor methods will result in the valuation being presumed reasonable. However, companies may also set fair market value through the “reasonable application of a reasonable valuation method.” This is generally a facts and circumstances approach based on all available information material to the value of the company, including the value of the company’s tangible and intangible assets, the present value of future cash flows, the market value of similar entities engaged in a substantially similar business, recent arm’s-length transactions, and other relevant factors such as control premiums or discounts for lack of marketability. A valuation method is more likely to be deemed reasonable if it is used for other purposes that have a material economic effect on the company or its stockholders or creditors.

The consequences of failing to comply with Section 409A are severe. Setting the exercise price at fair market value generally exempts a Stock Right from Section 409A, but a non-compliant valuation could cost a Stock Right holder accelerated income tax recognition in the year of vesting, a 20% federal penalty tax, a possible state tax penalty, and premium interest. If you have any questions about valuing stock right grants under Section 409A, please reach out to a member of the Kutak Rock [Employee Benefits and Executive Compensation practice group](#).

