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ASC 718 and IRC §409A

To comply with Accounting Standards Codification (ASC) Topic 718 (ASC 718) and Internal Revenue Code (IRC) §409A, companies must estimate the fair (market) value of their common stock. For private companies, this is often completed annually or after an event such as a round of financing or a development milestone. As companies approach liquidity events (such as an IPO) or other significant events, the frequency of common stock valuations often increases. Given the regulatory scrutiny on these valuations, understanding the technical requirements of ASC 718 and IRC §409A is critical. Provided below are summaries of each standard, as well as a description of the FASB's practical expedient for private companies for valuing share-based payment awards.

Overview of ASC 718

ASC 718 requires that fair value be determined for share-based payments, including share options and restricted shares, as of the grant date. In addition, it requires the fair value to be charged to compensation cost over the relevant vesting or service period. For ASC 718 purposes, fair value is defined as "the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale".

Privately held companies are challenged with estimating the fair value of their awards using Level 3 inputs given that there is no active market from which fair value may be observed. The fair value of their awards should be estimated by applying a valuation technique that would be used in determining an amount at which instruments with the same characteristics would be exchanged. Some of the more common approaches used include the following:[1]

- Recent sales of common stock to an unrelated party
- Recent sales of preferred stock to an unrelated party (with consideration given to differences in rights and preferences between common and preferred stock)
- Valuation by an independent third-party appraiser
- Internally-prepared valuation analysis

Generally, sales of common stock to an unrelated party provide the best estimate of fair value since they represent an arm's-length transaction, but these sales can be infrequent.

Sales of preferred stock to an unrelated party also provide a relevant data point for fair value. However, assigning value to rights and preferences in order to reconcile the fair value of the preferred stock to the fair value of the common stock can be challenging.

Regardless of the approach selected, companies are expected to develop reasonable and supportable estimates for each assumption used in the valuation model. As defined in ASC 718, an assumption is considered supportable if "it is based on reasonable arguments that consider the substantive characteristics of the instruments being valued and other relevant facts and circumstances".

[1] Any valuation performed by an independent third-party appraiser or management should incorporate the information provided by recent sales of common or preferred stock to an unrelated party.

ASU 2021-07

Although IRC §409A and ASC 718 have different objectives and value standards, companies often seek to be consistent in these estimates of fair (market) value. Due to the costs faced by private companies in complying with the requirements of both ASC 718 and IRC §409A, the Private Company Council (PCC) proposed an amendment to the valuation requirements under ASC 718, which was subsequently issued by the FASB in October 2021.

ASU 2021-07, Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards, a consensus of the Private Company Council, offers a practical expedient whereby private companies can utilize the acceptable valuation methodologies prescribed under IRC §409A to determine the current price of a share underlying an equity-classified share option.[2,3] For additional details about the practical expedient for private companies, refer to the KPMG Defining Issues article.

Overview of IRC §409A

IRC §409A establishes rules for deferred compensation arrangements. Failure to comply with the regulations can result in adverse tax consequences, often including significant monetary penalties.

The effects of IRC §409A are far reaching because of the broad definition of "deferral of compensation". IRC §409A applies whenever the service provider "has a legally binding right during a taxable year to compensation that is or may be payable to (or on behalf of) the service provider in a later taxable year". IRC §409A generally requires that a "nonqualified deferred compensation plan" complies with various rules regarding deferral elections. The timing and form of payment and methods of funding drive the amounts deferred under the plan for the current year. All previous years become immediately taxable as soon as vested. Nonqualified common stock options can be subject to IRC §409A unless an exception applies.

In such a case, the IRC §409A taxation is not limited to the discount between the exercise price and the fair market value of the option on the date of grant, but rather on the date of vesting of each tranche. Because of significant penalties, the details of deferred compensation plans need to be accurately recorded and evaluated.

Key exception

One of the key exclusions for nonqualified common stock options is when the exercise price of the options is equal to or greater than the fair market value of the underlying stock as of the option grant date. Fair market value is defined in Revenue Ruling 59-60 as "the price at which the subject property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts".

To qualify for this exclusion, the IRS provides guidance as to how private companies can establish the fair market value of their stock consistent with this IRC §409A exclusion. The stock must generally be the common stock of the employer or a parent or subsidiary of the employer. The IRS will accept a valuation of private company common stock if done by "the reasonable application of any reasonable valuation method". IRC §409A uses the IRC §401(a)(28) rules as the standard approach. Potential valuation methods outlined in IRC §409A include:

— Fair market value of tangible and intangible assets of the corporation

— Present value of future cash flows

— Market value of stock or equity interests in comparable companies.

In practice, the guidance provided in the AICPA practice aid, "Valuation of Privately-Held Company Equity Securities Issued as Compensation", is often considered in valuing the underlying stock because there is no explicit instruction provided in IRC §409A regarding acceptable valuation approaches and methodologies.

The valuation may consider other relevant factors, such as control premiums or discounts for lack of marketability, which are consistent with the standards discussed in Revenue Ruling 59-60 regarding valuation of private companies. Generally, the stock value is not discounted for any risk of forfeiture.

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[2] If a company uses a valuation performed by an independent appraiser when complying with the valuation requirements of IRC §409A, the valuation date must be within the 12 months preceding the grant date and reflect all relevant information that would materially impact the value of a corporation.

[3] The PCC determined that the practical expedient should not be available for liability-classified awards.

IRC §409A provides three "safe harbors" to avoid penalties when qualifying for this exception. Those proposed methods include:

— A valuation by an independent third-party appraiser

— In the case of an illiquid start-up corporation, a valuation prepared by a qualified individual applied at a time that the corporation did not otherwise anticipate a change in control event or public offering of the stock

— A generally applicable repurchase formula (applicable for both compensatory and noncompensatory purposes).

If one of the safe harbors is consistently used, it provides a presumption that the fair market value of the stock underlying the option is reasonable and places the burden on the IRS to demonstrate that the determination of fair market value or its application was "grossly unreasonable". Consistent with previous IRS valuation rulings, a valuation is considered reasonable if based on an independent appraisal as of a date which provides a reasonable proxy for the date of value.

IRC §409A prescribes limited guidance of what would be presumed an acceptable approach to estimating fair (market) value of common stock. Further, as discussed previously, the FASB is deliberating a practical expedient whereby valuations done in accordance with IRC §409A may be acceptable for purposes of compliance with ASC 718. Companies should monitor the outcome of the FASB amendment proposal when assessing the documentation required for compliance with ASC 718 and IRC §409A.

KPMG capabilities

As one of the leading providers of valuation services, the KPMG Valuation and Business Modeling Services practice brings a team of more than 400 multidisciplinary, highly experienced professionals located in major cities throughout the United States. With a well-established track record in the venture capital and private equity communities, our professionals have the technical and industry knowledge to effectively support the valuation requirements of venture-backed companies.

Services we provide

We provide valuation services designed to address unique client needs as dictated by ASC 718 and IRC §409A. These often fall within one of the following categories:

— Share-based payment and share option valuations

— Cheap stock valuations (i.e., share options, warrants, or common stock issued preceding an IPO for a price that is below the expected IPO price)

— Illiquid stock and start-up company stock valuations

— Capital structure valuations of highly leveraged companies, usually held by private equity investors

— Business enterprise valuations

— Tax-related valuations

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