Windeye Partners

409A Valuations & Non-US Companies – Issues to Consider

Introduction

Startup companies have in recent years become increasingly global in their operations. Early stage companies from Europe, Asia and other locations are often quick to establish a presence and hire staff in the US. Given the nature of startup companies, they also want to provide incentive compensation to key US staff. Consequently, these companies, which are sometimes relatively small, need to comply with US securities, tax and employee regulations.

The Internal Revenue Service (IRS) regulation 409A requires, among other things, that companies in the US show that stock options and other equity incentives issued to employees (and advisors) are not priced below "Fair Market Value" (FMV) when issued. Otherwise the companies and their employees may face penalties and tax consequences. For publicly traded companies a market share price is normally easy to obtain. However closely held companies, without shares traded in a public market, generally need to have a business valuation done at least once every year.

Foreign companies with a subsidiary and employees in the US that wish to provide those employees with stock options or other equity incentives are also subject to the same requirements, even though the stock options may be for shares in the foreign parent company rather than a US subsidiary. In addition, some foreign companies undertake an "inversion" of their structure, where a US company becomes a new parent company with the original foreign company now operating as a subsidiary, if the shareholders believe this structure can help them better access capital in the US. The 409A regulations regarding an annual business valuation also apply in this case.

409A Regulation

IRS code section 409A was enacted in 2005 and regulates the taxation of "non-qualified deferred compensation" for employees of all US companies, including the issuance of non-qualified stock options and stock appreciation rights. The definition of "non-qualified" deferred compensation plans do not include Incentive Stock Options, 401(k)'s and similar "qualified" plans.

If non-qualified stock options or similar instruments are issued with a strike price that is below the Fair Market Value at the time of issuance, then the difference between the strike price and Fair Market Value will be taxable income for the recipient. In addition, tax penalties (20%) may apply if some time has passed since the stock options were granted. Therefore a private company should always perform a valuation in order to demonstrate that the strike price is at or above fair market value at the time of issuance (for a public company the stock market provides the value).

According to the IRS, "Fair Market Value may be determined through the reasonable application of a reasonable valuation method." Fair Market Value is defined by IRS Revenue Ruling 59-60 as: "the price at which the subject equity ownership 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 under no compulsion to sell, both parties having reasonable knowledge of relevant facts." An independent appraisal will be presumed reasonable if "the appraisal satisfies the requirements of the Code with respect to the valuation of stock held in an employee stock ownership plan." A company can rely on the valuation report for 12 months from the valuation date, unless there is a material change such as a financing sooner than that.

Overall, the IRS counsels that a 409A valuation should consider the following aspects:

- The value of tangible and intangible assets (Asset Approach);
- The present value of future cash flows (Income Approach);
- The market value of comparable businesses, both public and private (Market Approach); and
- Other relevant factors such as control premiums or discounts for lack of marketability.

The IRS has defined special rules for "start-up" companies with respect to 409A valuations. Start-up companies are defined as companies a) that have been in business for less than 10 years; b) that do not have publicly traded equity securities; c) and for which no change of control event or public offering is reasonably anticipated to occur in the next twelve months. For start-up companies, a valuation will be presumed reasonable if "made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors prescribed for valuations generally under these regulations." Also, such a valuation must be performed by someone with "significant knowledge and experience or training in performing similar valuations."

Thus, a board member or an employee of an early stage company may be able to perform a 409A valuation for that company. However, in most situations this the company will seek an independent valuation from an external provider.

The IRS provides a 12-month "safe harbor" period for a 409A valuation with respect to the strike price for option grants. After 12 months, or when a "material event" such as a financing occurs, a new valuation will be required.

AICPA Guidelines

Normally 409A valuations are prepared to comply with the IRS regulations outlined above as well as guidelines issued by the American Institute of Certified Public Accountants (AICPA) for the use of options or shares as compensation ("Valuation of Privately-Held-Company Equity Securities Issued as Compensation") which specify how these securities should be valued for accounting purposes by US companies. While there may exist some differences between how a specific security should be valued for accounting purposes (which follows a "Fair Value" standard) versus value for tax purposes (which follows the "Fair Market Value" standard outlined above) these are generally assumed to be insignificant in the case of a 409A valuation.

409A Valuation Issues with Non-US Companies

When performing a business valuation for 409A purposes involving a foreign parent company or a US company with most of its operations abroad, a valuation analyst will encounter some specific issues not usually present. These include:

- Equity incentive plans structured differently from the US:
  - In order to be able to issue options, one of our clients needed to establish a trust to which the company issues non-voting shares. Options are then issued on these non-voting shares.
- Company information may only be available in another language:
  - While financial statements can normally be prepared in English, supporting documents are not always. For example, the software development team and substantially all assets of one of our clients were in Estonia.
- Accounting standards differ from the US:
  - The use of IFRS for many European and Asian countries as well as the use of statutory reporting principles in smaller countries often requires the adjustment of asset and revenue valuations to be in line with GAAP bases.
- Dual-purpose 409A valuation may not be practical:
  - For US companies the 409A valuations are typically prepared to comply with both tax regulations and with accounting guidelines to provide the expense of equity compensation. With non-US companies the AICPA guidelines may not be applicable.
- Comparable data (public companies, transactions) may be harder to find:
  - Fewer public companies listed in foreign markets means that it is more difficult to find available comparables, and information disclosure is sometimes less generous than in the US.
- Cost of capital calculations differ from the US:
  - Equity market risk will typically be higher than in the US, while government bond yields can be higher or lower than in the US. For example, government bond yields in Switzerland were generally negative during 2017 thus complicating the basis for a standard cost of capital estimate.
- Data to support discounts for lack of control and marketability may not exist:
  - In 409A valuations it is typically important to apply a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) given that a small share interest will be worth less than its nominal proportion of a 100% equity value due to lack of control features and marketability. However these estimates often rely on empirical studies of the US stock market or data from US stock market transactions with no equivalent for international markets.
- Need to determine where the company's main market for products/services is or will be:
  - Even though a company is domiciled abroad, if the US market will be its main focus using cost of capital estimates and comparables from the US may be more appropriate.

Overall, developing a 409A valuation for either a foreign domiciled company or a US company with important foreign operations requires an additional skillset and familiarity with international markets.

Summary

Foreign early stage companies that have a US subsidiary and wish to provide equity incentives to US staff members need to be familiar with the IRS 409A rules, and the same applies when reincorporating a foreign early stage company in the US (i.e. an inversion of structure). While tax penalties may be applied later in the absence of a 409A valuation, the more important near-term issue is that not having performed a 409A valuation is likely to become an issue in the due diligence process when the company is seeking additional funding or negotiating a sale or merger. Having to do a 409A valuation in a hurry and, at that point with respect to a date perhaps several years earlier, is costly in terms of fees and potentially also in the form of reduced negotiating leverage.

In order to perform a 409A valuation where the parent company is domiciled in a foreign location, or has most of its operations in a foreign location, the valuation service provider needs to be familiar with these countries, their financial standards and languages. Companies in these situations should therefore carefully consider the experience of the valuation professionals who would provide the service before making a selection.

About Us

Michael Guthammar is a Certified Valuation Analyst (CVA) and member of the National Association of Certified Valuators and Analysts (NACVA), a member of the New York State CPA Society (NYSSCPA) Business Valuation Committee, and the founder of Windeye Partners. He has more than 25 years of experience advising companies, business owners, entrepreneurs, family offices, and investment funds in the US, Europe, Middle East and Asia regarding business valuations, intellectual property valuations, corporate finance, and mergers & acquisitions.

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