APPLICATION OF SECTION 409A TO STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

The attraction of stock options to executives and employees is that they themselves control the timing of income recognition by timing the exercise of the option. If section 409A applies to the option, this flexibility is lost, substantially eliminating the value of the stock option. To avoid taxation under section 409A, the option must either be specifically exempted from section 409A or meet certain requirements as outlined below.

Incentive stock options issued pursuant to IRC section 422 and stock options issued under an employee stock purchase plan pursuant to IRC section 423 are specifically exempted under the regulations from section 409A provided that they continue to meet the applicable qualification requirements of those sections of the IRC.

For stock options not issued pursuant to section 422 (“nonqualified options”), there are four basic requirements that must be met to be exempt under section 409A, as follows:

1. For nonqualified stock options, the exercise price must be at least equal to the fair market value of the underlying shares as of the grant date. For this purpose, if the grantee is entitled to dividend equivalents at exercise, they will be treated as a reduction to the exercise price; i.e., the grant will be considered as issued at an exercise price below fair market value at the date of grant and subject to section 409A. The following specific valuation requirements apply to the determination of “fair market value” of the common stock at the date of grant:
   a. A public company must base fair market value on a reasonable method using actual sales of its common stock such as the last sale, closing price or average price on the day before or the day of the

**EMPLOYEE BENEFITS**

Be Aware (Beware) — Discounted Stock Options are Subject to 409A

By Peter Alwardt, CPA

Many small, closely held companies, especially start-up companies, like to issue stock options to key executives and employees as both an incentive to help grow the company and as a substitute for cash compensation when they need the cash to invest in the business. At times, the owners are unaware of the requirements under Internal Revenue Code (“IRC”) section 409A as it applies to stock options and stock appreciation rights (collectively “options” or “stock options”) and fail to appropriately determine the exercise price. At other times, they simply don’t want to pay for a valuation of the business to establish the exercise price. In both instances, the tax consequences for executives and employees can be disastrous.

**BACKGROUND**

IRC section 409A provides comprehensive rules regulating the taxation of nonqualified deferred compensation. While section 409A does not explicitly define a “deferral of compensation,” the IRS has been consistent in its position that discounted stock options are deferred compensation subject to section 409A throughout its notices, proposed regulations, and the final regulations. Specifically, IRS Notice 2005-1 states that if a stock option is granted with an exercise price that is less than the fair market value of the underlying stock on the date of the grant, the option will be treated as a deferral of compensation and will be subject to the requirements of section 409A.

*In conducting field audits, the IRS is clearly looking at stock option grants with respect to whether the option was granted at fair market value.*
option grant. Further, a company may use an average over a specified period in certain circumstances (typically related to grants to employees in foreign jurisdictions in order to comply with local tax law). However, the terms of the grant and the averaging period must be specified in advance of the grant date of the option.

b. A private company must base fair market value on a reasonable application of reasonable valuation methods based on all relevant facts and circumstances, and factors such as the value of tangible and intangible assets, the present value of anticipated cash flows, stock value of comparable entities, recent arm’s length sales, and valuation methods used for other non-compensatory purposes. Under the section 409A regulations, three safe harbor valuation methods are presumed to be a reasonable valuation (shifting the burden of proving unreasonableness to the IRS) for this purpose, as follows: (i) an independent appraisal within the prior 12 months that meets the requirements for valuing stock held by an employee stock ownership plan, (ii) a formula-based valuation that would be considered a nonlapse restriction under section 83 and will by its terms be used as long as the stock is not publicly traded, provided that it is used for both compensatory (options, stock appreciation rights, etc.) and noncompensatory transactions (not required for a sale of all or substantially all of the company’s stock), or (iii) in the case of an illiquid start-up company (generally in business less than 10 years with no publicly traded class of securities and not anticipating a change of control within 90 days or a public offering within 180 days), the regulations require a valuation by a “qualified,” but not necessarily independent, individual (5 years of experience in business valuation, appraisal, finance, investment banking, secured lending, etc.).

2. The stock subject to the nonqualified option grant must be solely stock of the entity receiving the services of the service provider or any corporation that owns a controlling interest in the service recipient or that is included in a chain of companies each of which is controlled by another company ending with the ultimate parent company. For purposes of determining a controlling interest, the controlled group rules under IRC section 414 for qualified retirement plans are applied by substituting at least 50% ownership for the at least 80% ownership requirement under those regulations. The 50% ownership requirement is reduced to 20% where there are legitimate business criteria for the granting of the option due to the relationship between the service provider and the optioned entity.

3. Only stock that qualifies as eligible common stock may be subject to a stock option granted to the service provider. For this purpose, section 409A allows the use of any class of common stock as defined under IRC section 305 of any eligible service recipient (as discussed in 2 above). The stock may be subject to restrictions, but may not have any dividend preferences of any kind. Liquidation preferences are permitted, but the stock may not be subject to a non-lapse mandatory repurchase obligation or put or call right at a price other than fair market value.

4. The stock option may not provide for a deferral feature (i.e., cannot provide for the deferral of the delivery of the shares upon exercise) or be exchanged for other deferred compensation. Material modifications to an existing grant are treated as a new grant subject to the requirements of section 409A and will likely require re-pricing. Extensions of the right to exercise are permitted up to the lesser of the original exercise period as specified under the option grant or 10 years. Underwater options may be extended without restrictions. For this purpose, they are treated as a new grant with an exercise price that exceeds the current fair market value of the stock.

**TAX CONSEQUENCES OF FAILURE TO COMPLY**

If any of the requirements of section 409A outlined above are violated, the nonqualified stock options or SARs are immediately taxable or, if later, upon vesting (when the stock option is no longer subject to a substantial risk of forfeiture). The amount recognized as ordinary income by the grantee is the excess of the fair market value of the stock at December 31 less the exercise price and any amount paid for the option at grant. In addition, section 409A imposes a 20% penalty tax on the compensation recognized and interest (if applicable) at the IRS underpayment rate, plus 1%. Further, any appreciation in the value of the option in subsequent years is also taxed
IRS AUDIT ACTIVITY AND FEDERAL CLAIMS COURT RULING

In conducting field audits, the IRS is clearly looking at stock option grants with respect to whether the option was granted at fair market value. The IRS may consider this an easy way to generate additional revenue for the federal government as indicated by their assessment of additional taxes of $3.5 million against the CEO of Marvel Technology Group Limited for having received discounted stock options. The case, 

Sutardja v. United States, is not yet settled; however, in an initial ruling the Court of Federal Claims confirmed that section 409A applies to stock options. Still to be decided in the case is whether, based on the facts, the options granted were in fact granted at a discount to fair market value. With confirmation that section 409A applies to stock options, the IRS will continue to scrutinize option grants.

CONCLUSION

All businesses need to be aware of the rules applicable to the granting of stock options and SARs to their employees. Closely held businesses need to be acutely aware of the valuation requirements related to stock and appreciation right grants under section 409A to avoid the extremely harsh tax consequences imposed on the employee for failure to comply with these rules.

Peter Alwardt is a tax partner with more than 20 years of consulting experience, specializing in employee benefits, tax and ERISA issues for domestic and international clients. Questions? Contact Peter at 212.891.6022 or peter.alwardt@eisneramper.com.

REVENUE RECOGNITION

Revenue — The World of Changes Is Here Soon

By Yan Zhang, CPA

After almost a decade of work and many revisions, the FASB issued a new revenue standard “Revenue from contracts with customers” in May of 2014. The principles-based standard left users with many unanswered questions about interpretations and implementation. In the last year and a half, the FASB’s Transition Resource Group (“TRG”) and various AICPA industry groups have worked to identify and resolve these issues.

The guiding principle of the new standard is to recognize revenue to depict the transfer of control over the promised goods or services via contracts with customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

As a reminder, to accomplish the principle there is a 5-step process:

1. Identify the contract. The standard applies to a company’s contracts with its customers except for contracts that are within the scope of other literature (i.e., leases).

2. Identify separate performance obligations. The unit of account for revenue recognition under this standard is the performance obligation (both goods and services). A contract may contain one or more performance obligations. Performance obligations will be accounted for separately if they are distinct.

3. Determine the transaction price. The transaction price includes all amounts that an entity expects to be entitled to in exchange for the promised goods or services. The transaction price may include an estimate of variable consideration.
4. Allocate transaction price to separate performance obligations. The transaction price is allocated to all of the separate performance obligations.

5. Recognize revenue when (as) each separate performance obligation is satisfied. Revenue is recognized when an entity satisfies a performance obligation by transferring control of the promised goods or services. Goods and services can be satisfied at a point in time or over time.

That sounds easy. However, based on the issues addressed by the TRG and their discussions and the revisions that the FASB is making to the standard, it turns out that this change in revenue recognition it is a difficult task. The TRG has received more than 70 submissions/questions that constituents have in interpretation or implementation of the standard. They have discussed these issues and where they believe that more guidance is needed they have recommended to the FASB changes/clarifications to the standard. Based on the work of the TRG and others, the FASB has amended or proposed to amend the standard in 4 separate exposure drafts which cover a wide range of topics:

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<th>TOPIC</th>
<th>CURRENT STATUS</th>
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<tr>
<td>1. Identifying Performance Obligations and Licenses</td>
<td>Exposure draft issued in May 2015</td>
<td>Q4 2015</td>
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<tr>
<td>2. Narrow Scope Improvements and Practical Expedients</td>
<td>Exposure draft to be issued in Q4 2015</td>
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<td>3. Principal vs. Agent (reporting revenue gross vs. net)</td>
<td>Exposure draft issued in August 2015</td>
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<tr>
<td>4. Effective Date</td>
<td>ASU 2015-14, was issued on August 12, 2015</td>
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People who have followed the revenue standard have gotten tired of trying to keep up with the changes that the TRG and the FASB have been proposing as they came to a new revenue standard. It’s common to have the attitude of “wait until they are done.” Well, our period of wait and see seems to have come to an end.

Even with a 1-year delay in the effective date, the standard is right around the corner and the adoption and implementation may be more difficult than you expect. Calendar-year-end public companies who are retroactively adopting will have to revise their revenue recognition beginning January 1, 2016 (a mere few months away).

Depending on a company’s business model, the effects on revenue recognition timing could be significant, which will impact key performance measures upon which compensation is determined and debt covenants are calculated. Companies need to allow time to deal with these secondary changes and don’t want to miss out on a bonus or fail debt covenants upon adoption.

In addition, currently there are fewer required revenue disclosures. However, with most new standards, there are many additional new disclosures required both annually and quarterly. When planning for adoption, preparers should not forget to gather the information necessary for disclosure (or make plans to spend long nights doing so after the fact.)

Some companies have found they need to change their information technology systems to be able to account for the new way to recognize revenue and prepare disclosures, and of course, there are the dreaded internal control considerations as a result of the new recognition criteria.

Adoption and implementation does not get easier when postponing the analysis or delaying the decisions. As TRG and FASB work diligently to wrap up the remaining implementation issues, it’s time to put revenue recognition front and center again in your action plan.

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This content was originally published as part of SEC Developments, our newest blog and newsletter.
Properly reporting and accounting for royalties can be challenging and complex for licensees. Ensuring that your licensees are operating as intended and paying you properly can be daunting for licensors. However, no matter how technical royalty and contractual obligations may be, there are a number of straightforward actions that both licensors and licensees should consider and take to better understand their contractual obligations. Doing so will place licensees in a better position to adhere to the terms of licensee agreements and will enable licensors to protect their rights and properties proactively.

For licensors: Know as much as you can about your licensees. By undertaking some reasonable due diligence, licensors can learn how the licensee operates. It is important to ensure that the licensee’s business and accounting systems/controls are structured in a way that enables them to adhere to the financial provisions of your license.

Knowing how the licensee conducts and accounts for their business will allow you to draft a license agreement with well-defined and clearly stated financial provisions that are tailored to your licensee’s business environment. This will enhance your licensee’s ability to comply with such provisions resulting in more accurate royalty accountings. Countless times I have heard licensees comment that the contractual sales, discounting and reporting requirements are not in sync with their business model. Thus they try to apply their model into the contractual reporting requirements, which can result in royalty disputes that can become costly.

For licensees: Enter into agreements that make sense financially. There’s real risk in assuming you can change or circumvent the contractual terms after the game has started. Similarly, have a thorough understanding of the financial provisions and be sure your understanding is in sync with licensor. Being on the same page helps avoid incurring unexpected royalty costs.

We have been involved in situations where the licensee reported royalties based on their business model and not the agreement, resulting in large royalty underpayments. Their argument that the agreement did not consider the characteristics of their business did not resolve the dispute and proved costly.

Licensors should be proactive in protecting their properties. The key is: “Trust but Verify.” Monitor your licensee and your licensed products in the marketplace. Is your licensee having financial problems, do they have a lot of turnover, are they growing rapidly or were they just acquired? If so, there is a greater chance that royalties are not being reported properly. Compare your licensee’s royalty accountings to product approval files to identify both unreported products and sales of unapproved products; identify where your products are being sold at retail; and monitor the Internet. This intelligence can be used to determine if problems exist. Know the limitations of your contractual audit provision so you don’t lose the right to audit older statements. Exercise your rights in a nonpunitive manner by managing expectations. Royalty auditing is commonplace, so don’t be afraid to audit your licensee. The marketplace knows when licensors are passive and may take advantage. We have seen 10 to 20 percent increases in royalty revenue for established licensors after commencing a royalty compliance program.
Licensees should build a reputation for rendering accurate and transparent royalty statements. Take advantage of the tools at your disposal. Explore the functionality of various brand licensing software packages. Implement a package that fits your model and/or the reporting requirements of your largest licensors. This will enhance your ability to monitor minimum guarantees, deadlines and milestones and to report accurately. Additionally, licensing software creates an archive of accounting records to support your royalty accountings that are subject to audit, which can extend over many years. Being known as a licensee with accurate and transparent royalty statements is a competitive advantage.

**For both licensors and licensees:** Document all revisions to the agreement in writing even for temporary or immaterial issues. License agreements are often amended verbally, which can result in problems down the road, especially when personnel changes. It is commonplace to find that small requests are not documented when the use of a simple confirming email could suffice. Consider documenting all changes to your license agreements either formally or informally.

We had a situation where a licensee purportedly received a verbal waiver to discount a product beyond contractual limitations and to sell the product outside of the licensed channels. Because the licensee could not document the waiver and the license had subsequently been acquired by another entity, the licensee ended up having to pay additional royalties for the excessive discounts.

**The bottom line for both licensors and licensees:** Create systems, processes and procedures to enable you to understand, adhere to and monitor your license obligations. Clear and unambiguous licenses, coupled with honest, straightforward dealings, go a long way toward mitigating costly problems and ruined relationships down the road. If both parties under a license agreement are successful, everyone wins!

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Charly Weinstein Named a 2015 Most Admired Peer by INSIDE Public Accounting

We’re very pleased to announce that our CEO, Charly Weinstein, CPA, has been named a 2015 Most Admired Peer by INSIDE Public Accounting, a national publication serving the accounting profession.

“Most Admired Peers typically share similar character traits,” said Kelly Platt, principal of the Platt Group and managing editor of INSIDE Public Accounting. “They’re great leaders, but not just within their own firms — they give back to the profession. This year’s Most Admired Peers can often be found sharing their knowledge and mentoring others. They believe in paying it forward.”

“It’s great to be recognized in this fashion,” said Weinstein. “Everyone at EisnerAmper is asked and expected to be a resource to and a voice for our profession, so this is very gratifying. I also would like to thank the people our firm has relied on over the years who have helped us achieve the status EisnerAmper enjoys today. I’ve received invaluable advice from my peers on countless occasions, and I’m thankful.”

Just months after EisnerAmper was acknowledged as the top accounting firm in each of the five aspects of service by Institutional Investor’s Alpha Awards, the firm has received recognition again. Hedgeweek, one of the hedge fund industry’s leading publications, announced that EisnerAmper was voted the Best North American Accounting Firm at its annual Hedgeweek USA Awards gala at the Intercontinental Hotel in New York City.

Hedgeweek’s audience, comprised of investors, fund managers and industry service providers, was surveyed earlier this year as the publication solicited input to recognize service provider excellence.

“We are proud of our reputation with Hedgeweek’s audience, which speaks to the commitment of our partners and staff to provide our clients with the very best combination of expertise and attention,” said Charles Weinstein, EisnerAmper’s Chief Executive Officer.