Section 409A valuations

In 2004, the US Congress passed the American Jobs Creation Act creating Section 409A of the Internal Revenue Code (Section 409A) in response to a perceived abuse of deferred compensation arrangements that were in the media spotlight in the wake of several significant corporate scandals at the time. Section 409A affects a broad array of compensation arrangements. Most start-up and emerging growth companies, in particular, should pay attention to the treatment of stock options, especially with respect to setting the exercise price for stock options.[1]

Adverse tax consequences for stock options granted at less than fair market value

Section 409A provides that a stock option granted with an exercise price that is less than FMV on its date of grant is a "nonqualified deferred compensation" arrangement. Most stock options are designed to give an option holder flexibility as to when to he or she can exercise the award after the stock option vests.

Section 409A, however, severely restricts the ability of a taxpayer to manipulate (whether by delay or acceleration) the timing of when to recognize income after a legally binding right to compensation is created and, as a result, a stock option that is inadvertently granted with an exercise price that is less than the grant date fair market value (FMV) likely will fail to comply with Section 409A.

Under Section 409A, nonqualified deferred compensation arrangements that do not comply with the Section 409A requirements are subject to the following adverse tax consequences:

Option holders:

1. Accelerated income tax recognition in the year of vesting (rather than on the date of exercise)
2. An additional federal 20 percent penalty tax
3. An extra 5 percent state penalty tax for California taxpayers
4. Continued taxation of further increases in the stock option's intrinsic gain (and continued application of penalty taxes) in future years until the stock option is ultimately exercised or otherwise expires and
5. Premium interest and other potential penalty taxes to the extent Section 409A taxes are not timely reported or withheld by the employer.

Employers:

1. An obligation to report a Section 409A violation on Form W-2 or Form 1099, as applicable and
2. Withholding of accelerated income taxes (but not FICA).

Determination of fair market value

A privately held company will avoid having a stock option be treated as "nonqualified deferred compensation" under Section 409A if, among other factors, the stock option is granted with an exercise price that is no less than FMV on the date of grant. [2]

Section 409A includes a burden of proof in establishing whether or not a stock option has been granted with an exercise price that is less than FMV on the date of grant.

1. If the employer uses one of the "safe-harbor" methods set forth in the final Section 409A regulations (described below) to determine the stock's FMV, then the IRS will presume the valuation is correct, and the IRS will have the burden of proof in showing that the employer was "grossly unreasonable" in relying upon the employer's valuation method.
2. If the employer chooses to not use a "safe harbor" method to determine the FMV of the company's stock, then the employer will have the burden of proof to show the IRS that the exercise price of the stock option is no less than FMV on the date of grant.

As a general matter, a reasonable valuation method is one that considers all available information that is material to the value of the company, which is applied consistently to determine valuations determined for both compensatory and non-compensatory purposes. In addition, a valuation method becomes invalid the moment it fails to reflect all available information that is material to the value of the company. Last, Section 409A valuations generally expire after 12 months, if not already expired due to new information material to the value of the company.

Section 409A "safe harbor" valuation methods

The Section 409A regulations provide for three "safe harbor" methods:

1. **Qualified independent appraiser method.** The valuation is determined by a qualified independent appraiser as of a date no more than 12 months before the date of grant.

This is the most popular of the three safe harbor methods because of the current ability to obtain an independent valuation report at relative low cost from various appraisal providers and the credibility conferred by an independent expert's analysis and opinion.

1. **The illiquid startup method.** The valuation of the stock of a private company that has conducted business for 10 years or less and is not reasonably expected to undergo a change in control within 90 days or a public offering within 180 days of the date the internal valuation report is used will be presumed reasonable if:

- The valuation was performed within the past 12 months by a person "with significant knowledge and experience or training in performing similar valuations." The applicable standards for this required expertise are described in IRS regulations.
- The valuation is evidenced by a written report.
- The valuation considers the following relevant valuation factors:
- 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 and
- Other relevant factors such as control premiums or discounts for lack of marketability.
- The common stock is not subject to put or call rights or other obligations to purchase such stock (other than a right of first refusal or other "lapse restriction" such as the right to purchase unvested stock at its original cost).

1. **Non-lapse restriction valuation method.** This method likely is available only to a relatively small number of emerging growth companies, as the valuation must be based on (a) a non-lapse restriction ("buy/sell agreement"), which requires the transferee to sell such common stock only at a formula price based on book value, a reasonable

multiple of earnings, or a reasonable combination thereof, and (b) that 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 common stock, such that the formula acts as a substitute for the value of the underlying stock.

Practical considerations for granting stock options

For these reasons, it is very important for employers to ensure that they have strong corporate governance processes in place when granting stock options to ensure that stock options have proper exercise prices (and, therefore, avoid classification of a stock option award under Section 409A as nonqualified deferred compensation).

Further, we note that the developmental stage of a start-up or emerging growth company typically has a large influence on the valuation method adopted.

1. *Pre-funding*. At the earliest stages, before a company has significant funding (*eg*, pre-Series A), the valuation methods described above may prove difficult to obtain or procure for various reasons. Accordingly, at this stage, companies may wish to sell stock to employees or consultants that is subject to vesting (*ie,* stock purchase rights or restricted stock bonuses), rather than grant stock options. These stock arrangements are complex in their own right, but they should not be regulated by Section 409A and generally represent less tax risk.

To the extent stock purchase rights or stock bonuses are not desirable, then we normally would suggest that a company's board of directors work with its corporate counsel and other advisors closely and carefully consider the valuation factors described above in setting the FMV for stock options and document in detail the process for determining FMV in corporate resolutions when granting stock options.

1. *Series A funding to pre-liquidity*. Most venture capital-backed companies may choose to follow one of the "safe harbor" methods. Some companies may have the requisite expertise internally (*eg*, a member of the board of directors or the Chief Financial Officer) to use the illiquid startup method.

Given the potential liability involved, however, employers may want to ensure that they provide appropriate indemnification and D&O coverage to any officer or director involved in creating such a report.

We do not see this method utilized too often, however, because it can be relatively time consuming for a resource-constrained private company to put together a report that would satisfy the Section 409A requirements.

1. *Mid-stage to approaching liquidity*. We strongly encourage companies preparing for an IPO to use independent appraisals, both due to Section 409A concerns and as a potential means of comply with accounting rules and satisfy the US Securities and Exchange Commission with respect to potential "cheap stock" accounting issues.[3] Similarly, M&A buyers typically apply scrutiny regarding Section 409A issues. Accordingly, companies who have a trajectory to an M&A liquidity event will want to ensure that the valuation method used for stock option grants since inception will satisfy a potentially risk-adverse buyer.

[1] Please note that incentive stock options (ISOs) granted in a manner that comply with the terms and conditions applicable to ISOs under the IRC, including a requirement that the exercise price of an ISO be no less than grant date FMV, and that are not subsequently modified to a manner that causes loss of ISO status, are *not* regulated by Section 409A. That being said, most employers use the Section 409A valuation methods to comport with ISO rules as well as in granting nonqualified stock options. For this reason, we refer to stock options generally in this summary.

[2] In addition to the FMV exercise price requirement, stock options must satisfy a number of additional requirements to be exempt from Section 409A, including: (1) the option must be for common stock, (2) the number of shares subject to the option must be fixed on the date of grant, (3) the option generally should be granted by the employing corporation or a parent corporation, and (4) the option may not defer income recognition beyond the later of exercise or the date on which the shares purchased first become substantially vested.

[3] Please note that this summary is a general tax summary and does not cover the accounting considerations of issuing stock options below FMV.
