

**Proposed Code Section 409A Regulations
Prompt Reconsideration of Stock Valuations
for Equity Compensation Programs**

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The recent adoption of Section 409A of the Internal Revenue Code (“Code”) has prompted significant concerns about valuation practices relating to stock options and other forms of equity compensation. This Article gives an overview of Code Section 409A and its impact on stock option valuation and provides guidance on how to address its valuation requirements going forward.

Background

Last year’s enactment of Code Section 409A can penalize discretionary deferrals of compensation under “non-qualified deferred compensation arrangements” by imposing a 20% additional tax on the recipient (as well as interest-like penalties) unless specific requirements are met.¹ Code Section 409A affects not only traditional deferred cash payments, but also other compensation arrangements that have a similar economic effect of deferring tax on amounts earned in one year but not paid until a subsequent year such as stock options with in-the-money exercise prices at their date of grant.

Most companies are now examining their equity compensation programs in light of Code Section 409A. For nonstatutory stock option (“NSOs”) programs, companies are taking action to ensure that all NSOs are granted with an exercise price at (or above) fair market value. In addition, some companies are now performing valuation “check-ups” for options intended to qualify as incentive stock options (“ISOs”) to ensure that underlying stock was properly valued so that the options satisfy the ISO requirement and therefore not subject to Code Section 409A.

Beyond the additional tax that may be imposed by Code Section 409A, valuation issues may arise in related areas. In the transactional context, privately-held companies may start to see more detailed representations and warranties about the accuracy of their valuation methods coming from potential acquirors. Moreover, it is important for companies to adopt a reasonable valuation method to avoid potential liabilities for inaccurate tax reporting and withholding and potential lawsuits by option holders who unexpectedly face increased tax liabilities as a result of Code Section 409A.

Establishing Reasonable Valuations Under Code Section 409A

¹ Refer to Morrison & Foerster LLP *Client Alerts* entitled “Deferred Compensation Plans To Undergo Major Changes Under American Jobs Creation Act of 2004” ([link](#)); Deferred Compensation Update: IRS Issues Initial Guidance Notice 2005-1” ([link](#)); and “Deferred Compensation Update: IRS Issues Proposed Regulations under Code Section 409A” ([link](#)); and for a more detailed and technical discussion of Section 409A’s requirements.

Publicly-traded companies' stock trading price generally provides a reliable measure of stock value so that public companies can confidently conclude that the exercise price on a granted option will be not less than the fair market value of stock to which an option relates. However, for companies whose stock is not readily tradable in an established securities market, the Code Section 409A fair market value determination is more complex.

Recently proposed regulations under Code Section 409A² identify the key factors that the IRS will use to assess the reasonableness of a proposed valuation method. The proposed regulations also provide three presumptively-reasonable valuation approaches that companies whose stock is not readily tradable in an established market can use.

The proposed regulations require the employer or other service recipient to use a "reasonable valuation method" to determine the value of stock underlying compensatory option grants. The reasonableness of any proposed valuation method will be based on the relevant facts and circumstances as of a specified valuation date. The IRS will consider the following factors to test the reasonableness of a proposed valuation method:

- The value of the company's tangible and intangible assets;
- The present value of the company's future cash flows;
- The market value of stock or equity interests in substantially similar businesses that can be determined readily by objective means;
- The effects of any control premiums and/or marketability discounts;
- Whether the proposed valuation method is used for other material purposes by the company, its stockholders, or creditors; and
- Other relevant factors.

The IRS will *not* consider a valuation method to be reasonable if it fails to take into account all information that is material to the company's valuation. In addition, a value that was previously determined under an otherwise-reasonable method will *not* be considered to be reasonable for purposes of Code Section 409A if *either* the determined value does not reflect after-acquired information with material effects on the company's current value *or* the value was determined as of a date more than 12 months before the date for which the valuation is being used. It is more likely that the IRS will accept the reasonableness of a valuation method if the same method is used for purposes unrelated to the compensation of employees or other "service providers."

As discussed in more detail in our recent *Client Alert* ([link](#)), the IRS has offered temporary relief from the valuation requirements included in the proposed regulations. In Notice 2006-4, the IRS indicated that a "good faith" valuation method that satisfies the requirements imposed by Code Section 422 and its related regulations, both of which govern the granting and administration of ISOs, will be deemed to be sufficient to establish the fair market value of stock options and stock appreciation rights granted on or prior to December 31, 2004. For stock options and stock appreciation rights granted on or after January 1, 2005, valuations may be performed using any

² As proposed, the Code Section 409A regulations (available at: <http://www.ustreas.gov/press/releases/reports/reg15808004.pdf>) will effective for taxable years beginning on or after January 1, 2007.

“reasonable valuation method,” as described in Notice 2005-1, the IRS’s initial guidance under Code Section 409A. These temporary exceptions will be available until the proposed Code Section 409A regulations are finalized.

Valuation Methods

A. Safe Harbor Valuation Methods

The proposed regulations describe three alternative valuation methods that will be presumed to result in a reasonable valuation if they are used consistently. These methods include—

- **Independent Valuation.** A valuation by an independent appraiser qualified to value employer securities held by tax-qualified employee stock ownership plans that is conducted no more than 12 months prior to the relevant transaction date (*e.g.*, the grant date for an NSO) assuming there are no subsequent material developments that would affect the accuracy of the valuation.
- **Formula-Based Valuation.** A formula-based valuation that is acceptable under Code Section 83, provided that the valuation is performed in a uniform manner for all compensatory and noncompensatory purposes (*e.g.*, regulatory filings, loan covenants, stock repurchases, and other third-party arrangements) and that is used consistently. We do not expect that this valuation method will be widely used, primarily because of its uniformity requirement.
- **Start-Up Company Valuation.** For the “illiquid stock of a start-up corporation,” a valuation made reasonably and in good faith by a person(s) with significant knowledge and experience or training in making similar valuations (including an insider) and evidenced by a written report that takes into account the relevant factors described above. We expect that many early-stage private companies will attempt to rely on this method assuming they can secure a valuation performed by a person with the requisite knowledge and experience.
 - In order to qualify for this valuation method, each of the following conditions must be satisfied: (i) the company has no trade or business that it or any predecessor has conducted for a period of 10 or more years; (ii) the company has no class of securities traded on an established securities market; and (iii) the none of the stock being valued is subject to put or call rights or obligations (other than rights of first refusal or typical repurchase rights for unvested shares).
 - Note that this valuation method will not be available if the company, employee or other service provider reasonably anticipate that, as of the valuation date, the company will undergo a “change of control” (within the meaning of Code Section 409A) or make a public offering of its securities within 12 months following the date of the valuation.

The IRS may rebut the presumed reasonableness of any of these valuation methods by showing either that the method itself or the application of the method was *grossly* unreasonable under the circumstances. Thus, the IRS will have the burden of proof to show that the valuation was unreasonable in such cases, and is likely to attempt to carry that burden only in extreme cases.

B. Alternative Valuation Methods

Companies are not required to use any of the three presumptively reasonable valuation methods but may instead use alternative methods that are otherwise reasonable. If a company chooses to use a non-safe harbor method, that method will not be deemed to be reasonable, and the company should be prepared to demonstrate the reasonableness of its alternative method based on the factors articulated in the proposed regulations (including the requirement that it has considered all relevant information bearing on the valuation) and in any subsequent IRS guidance.

C. Valuations for Incentive Stock Options

While ISOs are expressly excluded from Code Section 409A's definition of "nonqualified deferred compensation" vehicles, failure of an intended ISO to meet the requirements for treatment as an ISO now carries the additional risk of application of Code Section 409A. In order for a stock option to qualify as an ISO under Code Section 422, its exercise price on the date of grant must be equal to or greater than the fair market value of the underlying stock; a stock option that fails to satisfy this requirement (or the other requirements imposed by Code Section 422) is by definition an NSO and therefore potentially subject to Code Section 409A if it is granted at less than fair market value.

As with NSOs, the valuation process is the key to determining whether Code Section 409A will be applicable to ISOs issued by closely-held companies. An inaccurate valuation is not necessarily fatal to an ISO's qualification under Code Section 422 as long as it was the product of a good-faith attempt to ascertain the value of the underlying stock; the presence (or absence) of "good faith" is determined based on the relevant facts and circumstances. Where a closely-held company is involved, the IRS has indicated that the use of an independent and well-qualified expert to perform the valuation will generally satisfy the "good faith" requirement.³ Thus, an ISO with a defective but good faith valuation will retain its status as an ISO *and* will therefore not be subject to Code Section 409A.

D. Consistency Requirement

The proposed regulations are clear that companies must consistently use the valuation method they chose. The "consistent" use of a valuation method generally requires that the chosen method be used for *all* equity compensation arrangements. A company *may* prospectively change the valuation method it uses for future equity compensation awards including stock rights. Although the proposed regulations do not impose formal limitations on the frequency of such changes, the IRS could question the basis for frequent changes in valuation method in light of the general consistency requirement discussed above.

Model Board Resolutions

Attached are sample Board resolutions that can be tailored for use in documenting a valuation under Code Section 409A and its proposed regulations. It is important to understand, however, that the adoption of these resolutions will *not*, in and of itself, satisfy the reasonable valuation requirements imposed by the proposed regulations. Instead, the resolutions are intended to

³ As discussed above, IRS Notice 2006-4 adopts this "good faith" approach to valuation for stock options (ISOs and NSOs) and stock appreciation rights granted on or before December 31, 2004.

document the Board's review and approval of a separate valuation report prepared in compliance with the proposed regulations (or, pending their finalization, in compliance with the relief granted by IRS Notice 2006-4). Note also that if a company opts to use a valuation method other than one of the safe harbor methods described in the proposed regulations, it must be prepared to demonstrate that the selected method takes into consideration the factors discussed above and results in a reasonable valuation. In this situation, additional resolutions should establish the basis for the Board's determination that the factors were considered and the valuation was reasonable even though not within any safe harbor.

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Sample Resolutions Approving Valuation Report

Sample 1

As the next order of business, _____ reported on her research regarding valuation methodologies to determine the fair market value of the Company's Common Stock. The Board discussed all relevant factors impacting the valuation of the Common Stock [as set forth in the valuation report attached hereto as Exhibit ____], including, the value of the Company's assets, the present value of the Company's future cash flows, the value of comparable companies, the effects of any marketability discounts⁴, [the purchase price paid by investors for the Company's Series ____ Preferred Stock], the stage of product development and the book value and prospects of the Company in light of market conditions. After a detailed discussion [of the foregoing factors and other analysis contained in Exhibit ____] and upon motion duly made, seconded and unanimously approved, the following resolution was approved:

RESOLVED, that the Board hereby determines, after due consideration of all relevant factors [as set forth in the valuation report attached hereto as Exhibit ____], in good faith that the fair market value of the Company's common stock on the date hereof is \$_____ per share as reflected in such report.

Sample 2

RESOLVED, that the Board of Directors hereby determines, after due consideration of all relevant factors [as set forth in the valuation report attached hereto as Exhibit ____], including without limitation, the value of the Company's assets, the present value of the Company's future cash flows, the effects of any marketability discounts⁵, the value of comparable companies, and other factors the Company deems relevant (including [the purchase price paid in the most recent non-issuer sale of the Company's preferred stock], the earnings history, book value and prospects of the Company in light of market conditions generally), that the fair market value of the Company's common stock on the date hereof is \$_____.

⁴ These resolutions assume that the valuations are for minority interests. If the valuation is of a majority or controlling interest, then the resolutions should add a reference to "the effects of any control premiums."

⁵ See Footnote 4.