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Pricing Private Company Stock Options to Avoid the Pitfalls of IRC 409A

The enactment of Internal Revenue Code (the "Code") Section 409A has resulted in significant challenges for private companies that award employee stock options. Under the final Treasury regulations, stock options that are awarded with an exercise price less than the fair market value of the underlying stock on the date of grant ("discounted stock options") constitute deferred compensation and will typically result in adverse tax consequences to the option holder and tax withholding responsibility for the awarding company.

The adverse tax consequences include immediate taxation at vesting, which most likely will be based on the "intrinsic value" of the option on the vesting date (i.e., fair market value of the stock at vesting less the exercise price). In addition to immediate taxation, a 20% federal "additional" tax will be imposed on the amount subject to tax at vesting, and interest at the underpayment rate plus 1% if the violation is discovered in a later tax year (the "409A Sanctions").

This article summarizes the valuation requirements under the 409A Treasury regulations (the "409A Regulations") as they relate to pricing private company employee stock options. The general valuation parameters provided in the 409A Regulations are summarized below as well as three specific valuation methods that, if utilized, create a presumption of reasonableness. General guidance is also provided for companies at various stages concerning the appropriate course of action when establishing the fair market value of their common stock for purposes of pricing stock options.

Determining the Fair Market Value of Private Company Stock

General Valuation Parameters

To assist private companies in pricing employee stock options, the final regulations provide guidance as to what the IRS will accept as a reasonable determination of fair market value. Under the 409A Regulations, as long as fair market value is determined by the application of a reasonable valuation method, the IRS will not impose 409A Sanctions regardless of whether the valuation proves to be inaccurate. The 409A regulations provide a list of factors that should be taken into account under a reasonable valuation method, as applicable. They include:

- the value of tangible and intangible assets;
- the present value of future cash flows;
- the public trading price or private sale price of comparable companies; and
- control premiums and discounts for lack of marketability.

Other facts and circumstances the IRS will consider in determining the reasonableness of a valuation method include whether all available material information is taken into account and whether the valuation method is used for purposes other than establishing the exercise price of employee stock options. Additionally, the 409A Regulations provide that the valuation may be used for a period of not more than 12 months, and that if significant events (e.g., capital contributions, the issuance of a patent, resolution of material litigation, etc.) occur within this 12-month period, the valuation must be updated.

Presumption of Reasonableness

The 409A Regulations provide three valuation methods that, if utilized, provide a presumption of reasonableness. A company may determine fair market value under its own valuation method using the general valuation parameters referenced above, but if the valuation proves to be inaccurate, the burden will be on the company to prove that the chosen method was reasonable at the time it was applied. However, if a company uses one of the three "presumptive" methods, the IRS must show that the valuation was "grossly unreasonable" to rebut the presumption of reasonableness. The three presumptive methods include: (i) the independent appraisal presumption, (ii) the valuation formula presumption, and (iii) the illiquid company presumption.

Independent Appraisal Presumption

A valuation performed by a qualified independent appraiser that meets the requirements for valuing stock held by an employee stock ownership plan under the applicable sections of the Internal Revenue Code and regulations will be presumed to be a reasonable valuation method if it is used to determine the value of stock on a date that is not later than 12 months from the valuation date. This particular presumptive method is commonly referred to as a "409A Valuation."

Valuation Formula Presumption

A valuation formula (e.g., two times net earnings) used to determine the purchase and sale price in a shareholder agreement will be presumed reasonable if such formula is used in the same manner for all compensatory and non-compensatory purposes, including regulatory filings, loan covenants, issuances to and purchases of stock from nonemployees, and such valuation formula is used consistently for all such purposes.

Illiquid Company Presumption

A valuation made by a qualifying start-up company that is made in good faith and evidenced by a written report will be presumed to be reasonable if it takes into account the general valuation parameters referenced above. A qualifying start-up company is a company that does not have publicly traded stock and has been in business for less than 10 years. However, this method will not create a presumption of reasonableness unless the following conditions are met:

- the valuation is performed by a person or persons (internal or external to the organization) with significant knowledge and experience or training in performing similar valuations;
- the stock is not subject to any call or put right, other than the company's right of first refusal to purchase the stock upon an offer by a third party, or the company's right to repurchase the shares upon termination of employment; and
- the company does not reasonably anticipate that an IPO or change in control of the company will occur within 12 months of the date the valuation is applied to the grant of an employee stock option.

Conclusions

For purposes of determining fair market value, the 409A Regulations provide more proscriptive guidelines than the incentive stock option (“ISO”) regulations. The ISO regulations make no reference to any specific factors that should be considered in determining fair market value for purposes of establishing the exercise price. Instead, companies issuing ISOs are permitted to determine fair market value under any reasonable method, provided the determination is made in good faith. As long as the company makes a good faith attempt, the ISO pricing requirement is satisfied regardless of whether the attempt failed. The 409A Regulations, on the other hand, require more than just a good faith attempt. The final regulations identify specific factors that must be taken into account if applicable. If the IRS later challenges the valuation, it is the company’s burden to show that such factors were considered and the valuation was reasonable at the time it was applied. However, if the company uses one of the three presumptive valuation methods, then the burden is on the IRS to show that the valuation was grossly unreasonable.

In response to the more onerous 409A option pricing requirements, private companies must be more diligent in how they determine and document the methods and processes used to value their stock; but how much diligence is necessary? The answer to this question will depend on where the company is in the private company lifecycle. Some early-stage start-up companies may not be inclined to pay the cost of a 409A Valuation, particularly if they are at such an early stage that they have no real assets or financial history. A more practical approach for these companies is to be diligent in considering the general valuation parameters and document what was considered and the process of the determination, making a strong case that the valuation method employed was in fact reasonable.

The challenge is much greater for later-stage private companies. It is expected that these companies will be more inclined to bear the cost of an independent appraisal or perform a valuation in-house and rely on the illiquid company presumption. For companies at the later stage of the lifecycle (those that expect to undergo a change in control or IPO within the next 12 months), the illiquid company presumption is not available. These companies will most likely rely on the independent appraisal presumption, not only to avoid the adverse tax consequences of 409A, but also to prevent the financial accounting ramifications that result from issuances of cheap stock.

In summary, boards of directors of private companies must take greater care than ever when determining the exercise price of employee stock options. They should carefully consider the cost of utilizing one of the presumptive methods versus the risk of a 409A violation. If the decision is made to rely on the illiquid company presumption and perform the valuation in-house, the board should cautiously determine whether the company possesses the requisite expertise.

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