

IRS Regulation 409A – What It Means for Today’s CFO

Picture this: Your company, MyStock.com, goes public and you receive a letter from the IRS saying you owe taxes on options exercised that were deemed to be issued below “fair market value.” To add insult to injury, you’re also being assessed a 20% penalty and interest on the amount owed. Unfortunately for you, the IRS’s recourse is against you, not MyStock.com, for those options that were considered Nonqualified Deferred Compensation (NQDC) under Section 409A. You could sue MyStock.com for issuing the stock options improperly or you could band together with the likely others and file a class action against the company. If you’re the CEO or CFO you should be worried that the unhappy shareholders may prevail and that you may be subject to legal action under Sections 302, 304, and 906, CEO & CFO Certification and CEO & CFO Bonus Forfeiture, under Sarbanes-Oxley. All for not following the guidelines set forth in Section 409A.

Sounds far fetched? Not really. Many start-ups today are still using the old and financially unsupportable rule of thumb that the common stock price is one-tenth of the most recent preferred round. This rule of thumb is what creates the potential problem for many private companies. If the option was granted before January 1, 2005, the fair market value must have been determined in good faith by the company. The IRS will judge whether or not the determination was made in good faith based on all the relevant facts and circumstances. Unfortunately, the only form of fair market value determined in good faith accepted by the IRS is that of an independent and well-qualified expert. If the option was granted after January 1, 2005, the fair market value must have been determined using a reasonable valuation methodology and the company must have intended to grant the options with at least a fair market value exercise price. The AICPA publishes an excellent practice guideline, “[Valuation of Privately-Held-Company Equity Securities Issued as Compensation](#)”, which outlines the various methods of enterprise valuation and allocation of enterprise valuation among preferred and common stock. For many early stage companies, discounted cash flow (DCF) is the preferred method since market comparables may be difficult to obtain or asset valuation method may not be appropriate. Other relevant factors such as control premiums and discounts for lack of marketability should also be considered. DCF assumes that the company has a forecast financial plan at least 3 years in duration.

So, who can perform a fair market valuation? For a seed or first round of funding the CFO would be acceptable if he or she has experience performing a DCF analysis and can adhere to the AICPA practice guidelines. For companies that are in their second or later rounds it is recommended that the company obtain a valuation from an independent appraiser that satisfies the IRS requirements under Section 401(a)(28)(C) of the Internal Revenue Code. The reason for this recommendation is based on risk and the assumption of said risk. The more rounds of financing a private company raises, the greater the risk that an option grant may be declared a NQDC by the IRS if an internal person such as the CFO performs the valuation. If you are a CFO, why take on that risk and the potential negative fallout under SarBox? You are better off using

a reliable, experienced third party to perform the valuation. If the IRS still declares the grant to be a NQDC you may have recourse against the third party.

Now, you've performed your valuation and established the common stock price. How often do you have to update the valuation? At the bare minimum you should update your common stock valuation at least annually. A valuation that is more than 12 months old is not considered reasonable. It is also recommended that you update your valuation if you have had a new round of fundraising or a material event, such as a product launch, that would affect the enterprise value of the company. Information of a material nature after the date of the calculation that is not taken into consideration means the valuation is not reasonable under the IRS regulations. If you are using a third party this means additional expense that should be viewed as an insurance policy. Most reputable valuation firms charge between \$10,000 to \$40,000 for an annual valuation. More frequent valuations mean more expense. In some instances your VCs may have discounted arrangements with reputable valuation firms. Expect the price for a valuation to increase as you add more rounds of funding and more complexity. It may seem like a high price to pay, but reputable valuation firms do this work every day and can provide a company with valuable insight with regards to the allocation of enterprise value, forecast common stock price based on expected results or milestones, and reduction of enterprise valuation if the company misses its results or milestones. Their work can also be used to measure the impact of an IPO, merger or acquisition based on the company's enterprise valuation.

It is recommended that options be granted on a monthly or quarterly basis and priced at the current valuation of the common stock during the 12 months the valuation is valid. Vesting, however, is not tied to the setting of the option exercise price. If you are expecting a new round of funding to close and have a binding term sheet, or if you are expecting a material event like a product launch, the closer you get to that date you should probably consider waiting to price the options until you update your current valuation. It is better to be conservative if a known, highly likely event will impact the enterprise value and the common stock price.

You should also review previously granted stock options that could be subject to Section 409A to determine if they were issued at a discounted exercise price. If you determine that prior stock options were issued below fair market value you do have the ability to amend any grant of options to comply with Section 409A. Certain amendments, such as reduction of the exercise price (directly or indirectly), addition of a deferral feature, or extension of a stock option beyond the "safe harbor", or renewal of a stock option, are treated as material modifications and thus are deemed as issuance of a new stock option and subject to Section 409A. "Safe harbor" is defined as the later of: a) 2½ months after the date the option would otherwise expire, or b) the end of the calendar year in which the option would otherwise expire. If an option holder wishes to exercise a Section 409A stock option after March 15, 2006, said options should be amended to comply with Section 409A before they're exercised to avoid recognizing taxes, penalties, and interest under Section 409A. Remember, taxes under Section 409A apply to a stock option that is not exercised but deemed subject to Section 409A. The only way to avoid the tax is for the company to amend the grant and reset the exercise price to fair market value.

Finally, start-up companies are subject to Section 409A. They may escape IRS review, but you can be certain that the IRS will review the stock option pricing practices of a private company as soon as the company files public registration statement for an IPO or is merged with or acquired by a public company. The acquiring company may ask the start-up company to represent that none of the previously granted stock options are Section 409A stock options and may require long-term indemnification to back up this representation. If you have any questions or concerns about your option program, we strongly recommend that you seek the advice of your accountant or auditor, tax accountant, and/or legal counsel. Section 409A has many nuances that can be lost in the process and you don't want to make a mistake that would make your company's stock options subject to Section 409A.

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