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## Section 409A Stock Valuation Guidance For Privately-Held Companies

This News Alert discusses the impact of Section 409A ("*Section 409A*") of the Internal Revenue Code of 1986, as amended (the "*Code*"), on the determination of the fair market value of company stock for purposes of granting certain stock compensation awards while the stock is not publicly traded.

### I. APPLICATION OF SECTION 409A

Section 409A does not apply to grants of incentive stock options ("ISOs") or restricted stock. However, stock options will not qualify as ISOs unless, among other things, they are granted at an exercise price that is not less than the fair market value of the company's stock on the date of grant. The fair market value determination under the ISO rules requires a good faith attempt using any reasonable valuation method. The ISO regulations give as an example the valuation method described in the estate tax regulations. Whether there was a good-faith attempt to set the ISO option price at not less than fair market value depends on the relevant facts and circumstances. It is unclear whether the Section 409A guidance on stock valuation will have any impact on review of ISO valuations in the future.

Section 409A does apply to any award of stock appreciation rights ("SARs") or nonqualified stock options ("NQSOs") with an exercise price that is less than the fair market value of the company's stock on the date of grant. Section 409A can apply to any NQSOs or SARs that were (i) granted on or after January 1, 2005, (ii) granted prior to January 1, 2005 but were not vested on December 31, 2004, or (iii) vested on December 31, 2004, but "materially modified" after October 3, 2004. To date, for purposes of Section 409A, the Internal Revenue Service (the "*IRS*") has issued proposed regulations and other temporary guidance which can be relied upon until final guidance is issued to determine the fair market value of a company's common stock.

### II. OVERVIEW

For NQSOs or SARs granted on or after January 1, 2005 and before the effective date of the final regulations under Section 409A, a company may rely on the guidance set forth in Notice 2005-1, Q&A-4(d)(ii) or the methods described in the proposed regulations issued on September 29, 2005. Sections III and IV of this News Alert set forth the rules applicable to grants on or after January 1, 2005. For grants made on or before December 31, 2004, see Section V below.

### III. IRS NOTICE 2005-1

IRS Notice 2005-1, Q&A-4(d)(ii) provides that to determine the fair market value of a company's stock on the date of grant any reasonable valuation method may be used ("*Reasonable Valuation Method*"). The company



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can continue to rely on the Reasonable Valuation Method rule until the effective date of the final regulations under Section 409A which is expected to be January 1, 2007. If the company can demonstrate that the exercise price of an option or SAR is intended to be not less than the fair market value of the stock on the date of grant, and the value of the stock is determined using a Reasonable Valuation Method, that option or SAR will satisfy the requirements for exclusion from application of Section 409A. Under this approach the burden is on the company to establish that the valuation method and its application are reasonable.

The IRS Notice cites the valuation method described in Treasury Regulation §20.2031-2 of the Estate Tax Regulations as an example of a Reasonable Valuation Method. That regulation provides that, when valuing the company's stock, the company should consider the company's net worth, prospective earning power and dividend-paying capacity and other relevant factors, including, among other things: the goodwill of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. In addition, the company should consider nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth and prospective earning power and dividend-earning capacity.

#### IV. THE PROPOSED REGULATIONS – FACTS AND CIRCUMSTANCES OR SAFE HARBOR

The proposed regulations provide two approaches to determine the fair market value of a company's stock for purposes of NQSOs or SARs:

- A. Facts and Circumstances Valuation – A company can adopt any reasonable valuation method to value its stock, but it will have the burden to establish that both the valuation method and its application are reasonable.
- B. Safe Harbor Methods – If a company values its stock using one of the IRS's safe harbor methods, the IRS will have the burden of establishing that both the valuation method and its application are grossly unreasonable.

Regardless of which approach a company uses, the valuation method will be reasonable, only if it takes into consideration all available information that is material to the value of the company, and the company consistently applies the valuation method when it values its stock for other aspects of its business. In particular, the company must consistently use the same valuation method for all equity-based compensation arrangements. However, the company can change its valuation method prospectively for new grants, provided it applies the new method consistently. Once a company becomes publicly traded, it must use the methods for publicly-traded companies.

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**A. Facts and Circumstances Valuation under the Proposed Regulations**

1. The value is based on the facts and circumstances in existence at the time of valuation.
2. The valuation date does not need to be the same date as the date of grant BUT (i) must have been completed within the prior 12 months AND (ii) if valuation was not as of the date of the grant, the fair market value of stock granted must be adjusted to reflect information available after the valuation date that may materially affect the value of the company (for example, the resolution of material litigation or the issuance of a patent).
3. The valuation must consider all material information pertaining to the company, such as:
  - (i) the value of the tangible and intangible assets of the company;
  - (ii) the present value of future cash-flows of the company;
  - (iii) the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the company, the value of which can be readily determined through objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction); and
  - (iv) other relevant factors, such as (a) control premiums; (b) discounts for lack of marketability; and (c) whether the valuation method is used for other purposes that have a material economic effect on the company, its stockholders or creditors.
4. There is no written documentation requirement for the valuation. HOWEVER, since the burden of proof is on the company and the grantee/participant, in order to support that the company's valuation is reasonable and is being reasonably applied, the company should document its valuation in writing either in the compensation committee/board minutes or through a separate written report that documents consideration of all relevant facts and circumstances.

**B. Safe Harbor Methods under the Proposed Regulations**

There are three safe harbor methods available under the proposed regulations: (i) the independent appraisal method; (ii) the nonlapse restriction method; and (iii) the start-up corporation valuation method.

1. Independent Appraisal Method – This valuation method requires an "independent appraiser" (as defined in the proposed regulations) to determine fair market value no more than 12 months before the relevant transaction to which the valuation is applied (*i.e.*, the date of grant or the exercise of a SAR). "Independent appraiser" is an individual who:
  - (i) holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

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- (ii) because of the appraiser's qualification as described in the appraisal, is qualified to make appraisals of the stock being valued; and
- (iii) understands that an intentionally false or fraudulent overstatement of the value of the stock may subject the appraiser to a civil penalty under Section 6701 of the Code for aiding and abetting an understatement of tax liability and, moreover, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

An "independent appraiser" does not include (a) the company, (b) the grantee/participant, (c) any other party to the transaction in which the grantee or participant acquired the stock being appraised, (d) any person employed by any of the foregoing persons, (e) any person related to any of the foregoing persons under Section 267(b) of the Code or married to a person who is in a relationship described in Section 267(b) of the Code, or (f) an appraiser who is regularly used by any person described in (a), (b), or (c) and who does not perform a majority of his or her appraisals made during his or her taxable year for other persons.

2. Nonlapse Restriction Method – A "nonlapse restriction" is a restriction which by its terms will never lapse, such as a limitation subjecting the stock to a permanent right of first refusal in a particular person at a price determined under a formula, or a shareholders agreement that restricts transfer of the shares and subjects the shares to a permanent right of first refusal by the company. The valuation is based upon a formula that, if used as part of a "nonlapse restriction" with respect to the stock, would be considered to be the fair market value of the stock pursuant to Treasury Regulation §1.83-5, provided that:

- (i) such stock is valued in the same manner for purposes of (a) any nonlapse restriction application to the transfer of any shares of such class of stock (or substantially similar class of stock) and (b) all noncompensatory purposes requiring the valuation of such stock, including regulatory filings, loan covenants, issuances to and repurchases of stock from persons other than service providers, and other third-party arrangements; and
- (ii) such valuation method is used consistently for all such purposes.

Under Treasury Regulation §1.83-5, the determination of fair market value can be based upon book value, a reasonable multiple of earnings or a reasonable combination thereof. However, if book value is used, the book value used must be at the time when the book value is the most accurate measure of the value (for example, the book value on the date a SAR is exercised versus the book value on the date the SAR was granted).

**This method does not apply with respect to an equity grant that is payable in stock that is not subject to the nonlapse restriction.**



3. **Start-up Corporation Valuation Method – This valuation method does not apply if either the grantee/participant or the corporation may reasonably anticipate *as of the time of the valuation* that the corporation will either:**
- (i) undergo a "change in control" (as defined by Section 409A), or**
  - (ii) make a public offering within the 12 months following the event to which the valuation is applied (i.e. date of grant of an option or exercise of a SAR)**

The determination of fair market value for an illiquid stock of a start-up corporation must be:

- (a) Made reasonably and in good faith; AND
- (b) Evidenced by a **written report** that takes into account the following relevant factors:
  - (1) the value of the tangible and intangible assets of the company;
  - (2) the present value of future cash-flows of the company;
  - (3) the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the company, the value of which can be readily determined through objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction); and
  - (4) other relevant factors, such as (A) control premiums; (B) discounts for lack of marketability; and (C) whether the valuation method is used for other purposes that have a material economic effect on the company, its stockholders or creditors.

An "illiquid stock of a start-up corporation" is stock:

- (a) of the corporation for which the grantee or participant works (*i.e.* as an employee, director, or independent contractor);
- (b) of a corporation that has no trade or business that it or any predecessor to it has conducted for a period of 10 years or more (*i.e.*, not a spin-off entity or entity formed in connection with the purchase of substantially all of the assets of an existing trade or business);
- (c) of a corporation that has no class of equity securities that are traded on an "established securities market" (as defined by Section 409A); and
- (d) that is not subject to any put or call right or obligation of the service recipient/grantor or other person to purchase such stock (other than a (1) right of first refusal upon an offer to purchase by a third party that is unrelated to the corporation or the grantee or participant, or (2) right or obligation that constitutes a lapse restriction as defined in Treasury Regulation §1.83-3(i)).



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## V. PRIOR AWARDS

Section 409A also applies to all awards granted prior to January 1, 2005 that were not vested as of December 31, 2004, and to pre-2005 vested awards that are materially modified after October 3, 2004. For awards granted prior to January 1, 2005 but not vested as of December 31, 2004, so long as the award is not materially modified, if there was a good-faith attempt to set the exercise price of the award at a price not less than the fair market value of the stock subject to the award on the date of grant, the exercise price will be treated as being at least fair market value, and the award will be exempt from Section 409A. Whether there was a good-faith attempt to set the exercise price at not less than the fair market value of the stock subject to the award on the date of grant is based upon the relevant facts and circumstances.

For a NQSO or a SAR that was vested on December 31, 2004, any modification or extension of its term after October 3, 2004, is considered the granting of a "new option or appreciation right," and the NQSO or SAR would lose its grandfathered status. A "modification" is any change that provides the optionee with a direct or indirect reduction in the purchase price of the stock or an opportunity to defer income (e.g., amending a NQSO to permit the optionee to apply dividends accrued on the shares under the option toward the purchase price or which extends or renews the rights of the optionee). If the modification or extension causes the "new grant" to be at an exercise price that is not at least equal to the fair market value on the date of the "new grant," the modification or extension can cause the "new grant" to be treated as deferred compensation.

If you have any questions regarding the foregoing, or for assistance in complying with 409A, please feel free to contact one of the attorneys listed below.

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