Valuing Private Company Stock for Compensation Purposes - Practical Guidance

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Internal Revenue Code Section 409A, along with recent changes in financial accounting rules, has significantly increased the focus of private companies on accurately valuing their common stock for purposes of granting options and other equity incentive awards. Section 409A has upped the ante by imposing severe tax consequences on individuals for certain stock-based compensation that does not comply with the new deferred compensation tax rules, including stock options granted with an exercise price that is less than the fair market value of the company's common stock on the grant date.

This Update summarizes the key reasons for the increased focus on the valuation of private company stock and offers practical guidance for private companies and their boards of directors.

Why Do We Care More Now About Private Company Stock Valuation?

Section 409A Deferred Compensation Provisions Apply to Stock Options That Are Granted at Below Fair Market Value.

Under Section 409A, a stock option granted with an exercise price below the fair market value of the company's stock on the grant date (including through an inaccurate stock valuation) could result in significant federal income tax consequences for the option holder as the option vests. An option subject to Section 409A will give rise to recognition of income by the option holder as the option vests (rather than at the time of exercise), plus an additional 20% tax. This personal tax consequence is what makes Section 409A so significant.

In the past, the incentive stock option rules have always required ISOs to be granted at fair market value, but the consequences of being wrong on valuation were not as significant - options that would otherwise have qualified for ISO treatment would become nonqualified options, but no personal tax impact would occur until the option was exercised. Because most option holders do not exercise options and then hold the underlying shares for at least a year before selling them, most ISOs effectively become taxed similarly to nonqualified options, and the benefits of ISO status are rarely realized. As a result, the practical consequences of being wrong on the valuation were not as significant. Section 409A has changed that by providing for income recognition, plus the 20% tax, at the time of vesting.

Existing IRS Guidance on Section 409A. In December 2004, the Internal Revenue Service issued initial guidance on the deferred compensation tax rules of Section 409A and transition relief in Notice 2005-1. In September 2005 the IRS issued proposed regulations that generally incorporate and expand the initial guidance. In December 2005, the IRS issued additional guidance in Notice 2006-4 that provides valuation relief in some circumstances for stock-based awards granted before January 1, 2005. Until final regulations are issued and become effective, taxpayers must comply in good faith with Notice 2005-1, Section 409A and any future guidance of general applicability. Compliance with the proposed regulations, while not required, is deemed to be good faith compliance with Section 409A.

What Stock Compensation Is Affected by Section 409A?

- **Covered Stock Compensation**. The existing IRS guidance covers as nonqualified deferred compensation subject to 409A:
  - **Discounted Stock Options and SARs** - stock options and stock appreciation rights (SARs) with a discounted exercise or grant price (i.e., the exercise or grant price is less than the fair market value of the underlying stock on the date of grant).
  - **Deferred Stock Options, SARs and Restricted Stock Units** - Stock options, SARs or restricted stock units that include any additional deferral feature (e.g., restricted stock units that will pay out the underlying stock after rather than at - vesting of the restricted stock unit).

- **Excluded Stock Compensation**. Under existing IRS guidance, Section 409A excludes from covered nonqualified deferred compensation:
  - **Full-Price Stock Options** - employee stock options with an exercise price equal to the fair market value of the underlying stock on the grant date.
  - **Restricted Stock, Full-Price SARs and Standard RSUs** - standard restricted stock, full-price SARs that have no other deferral feature and restricted stock units that are paid as they vest.

How Should Private Companies Determine the Value of Their Stock?
Stock Valuation Guidance Under Section 409A Proposed Regulations. The Section 409A proposed regulations contain new valuation guidance, including some relief for private companies. For private companies generally, the fair market value of the stock means a value determined "by the reasonable application of a reasonable valuation method" that is applied consistently. The question is - what does that mean and what exactly does it require?

Factors From Section 409A Proposed Regulations. Factors to be considered under a reasonable valuation method include, as applicable

- the value of tangible and intangible assets,
- the present value of future cashflows,
- the market value of stock in similar companies engaged in substantially similar trades or businesses, 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
- other relevant factors such as
  - the existence of control premiums or discounts for lack of marketability and
  - whether the valuation method is used for other purposes that have a material economic effect on the company, its shareholders or its creditors.

Many of these factors may seem ill suited to early stage private company valuation situations, and traditional considerations used in setting option pricing for venture backed companies, such as discounts from preferred pricing, liquidation preferences and the like, are not mentioned in the regulations. Nevertheless, the new factors set the standard by which stock option valuation will be judged, and for now privately held companies need to work within this framework.

Valuation Must Use a Reasonable Method, Reasonably Applied, and Must Be No More Than 12 Months Old. Reasonable application of a reasonable valuation method requires that the method take into consideration all available information material to the value of the company. Under the regulations, a valuation methodology is not reasonable if it uses

- a previously calculated value that fails to reflect information available after the date of the calculation that may materially affect the value of the company or
- a calculation that is more than 12 months old.

A company's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation, will also support the reasonableness of the valuation method.

Status Quo Valuation Methods May Not Meet "Reasonable" Test. One of the more significant changes brought about by the Section 409A regulations is that the venture-backed company's typical approach of valuing common stock and setting option pricing based on a standard (if escalating) discount from the most recent preferred stock price no longer appears to be a reasonable method of establishing option pricing, at least on its own. That said, we believe that post-money valuations established in venture and angel financings, combined with liquidation models showing proceeds to common shareholders under given exit valuation scenarios, will indeed continue to be relevant and useful in supporting option pricing decisions, assuming that material developments affecting valuation subsequent to the financing are taken into account and that appropriate adjustments to that valuation are made.

We recommend that all private companies develop liquidation models to show how various enterprise valuation assumptions flow through their capital structures to the common shareholders. This should help to narrow the valuation task to determining an overall enterprise value for the company.

Safe Harbors - Presumption of Reasonableness. The Section 409A proposed regulations provide two primary "safe harbor" methods for valuing private company stock, consistent use of which will provide a presumption of reasonable valuation that the IRS can rebut only by showing that either the valuation method or its application was grossly unreasonable. Because this is such a new and therefore unpredictable area, with potentially dire personal tax consequences, we believe it makes sense for private companies to seriously consider taking advantage of the IRS safe harbors even early in their life cycles.

However, as discussed below, the safe harbors are likely not going to be realistic or practical for many very early stage companies with limited resources. Companies at the very early stage should weigh the benefits of the safe harbors against the risks of not using them and make a good faith effort to comply with the IRS requirements. For most companies that attract outside capital, we think there will come a point at which using the safe harbors will be justified, and the question of when that point comes will be a company-by-company decision depending on the particular circumstances.

- First Safe Harbor - Written Valuation Report for Illiquid Stock of a Start-Up Company. A valuation of "illiquid stock of a start-up" company will be presumed reasonable if it is made reasonably and in good faith by a person or persons with significant knowledge and experience or training in performing similar valuations and is evidenced by a written report that takes into account relevant factors among those described above.
To qualify for the written report safe harbor presumption for “illiquid stock of a start-up” company, a company and any predecessors must not have

- conducted a trade or business for a period of 10 years or more,
- a class of equity securities traded on an established securities market,
- any put or call right or obligation of the company or other person to purchase the company’s stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the company or employee or a right or obligation that constitutes a lapse restriction), or
- a reasonable anticipation, as of the time the valuation is applied, that the company will undergo a change in control event or IPO within the 12 months following the event to which the valuation is applied (for example, the grant of a stock option or exercise of a stock appreciation right).

We anticipate that companies wishing to rely on the written report safe harbor will seek to identify a board member (such as a venture capitalist or angel investor) or a financial executive with significant valuation experience to carry out the valuation required by the presumption. The work product required would be a written report that thoughtfully discusses the IRS valuation factors with reference to the company’s specific situation. There is no standard form or boilerplate report, although we can assist clients with the development of a template to guide the process.

One of the major limitations of this written report safe harbor is the requirement that the company not be reasonably anticipating an IPO or sale of the company within 12 months. As we all know, start up company liquidity events are rarely planned a year in advance, and there is a concern that the IRS could use 20/20 hindsight to cast doubt on option grants made under the written report safe harbor within one year of an IPO or sale.

**Second Safe Harbor - Independent Appraisal.** A valuation will be presumed reasonable if it is determined by an independent appraisal that meets specified requirements (performed by a qualified independent appraiser using traditional valuation methodologies, like those that would apply to an employee stock ownership plan appraisal) and is performed as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the grant date of a stock option). The downside of this safe harbor for most venture or angel backed companies is the cost - most companies will not want to go to the expense of doing an independent appraisal every year, much less each time they grant options. However, the advantage is that the 12-month look back upon a liquidity event that applies to the written report safe harbor does not apply here.

**Practical Tips**

Although the written report and independent appraisal safe harbors described above provide a presumption of reasonable private company stock valuation under Section 409A, we believe companies at various stages of development will approach compliance differently based on their perceptions of the relative risks and rewards.

**Newly Formed Companies.** Newly formed "pre-funding" companies often issue "founders' stock" to founders and may issue restricted stock, rather than stock options, to early hires. This can often be done tax efficiently due to the high risk nature of these businesses prior to external financing, which results in a relatively low value for the stock. Because the value of a newly formed company's stock is highly speculative (and relatively low), and because restricted stock is not subject to Section 409A, we expect pre-funding start-ups to continue and even increase the use of restricted stock. The downside of restricted stock is that you have an enlargement of the shareholder base, so we expect companies will continue to pursue this during the early "founder" and quasi-founder days of a company's life cycle when the employee numbers are still very small and the true founders remain in firm control over decision-making at the shareholder level.

**Early-Stage Companies.** For an early-stage start up that has received the external funding it needs to begin building a team, product and company, we expect that moving from founders' stock to stock options will still make sense. Once companies reach this stage, they generally begin to hire more aggressively, and the Section 409A stakes will begin to rise as the numbers of employees increase and the company begins to make progress and build value as a business. Unless they are self-funded by founders with means, companies at this stage will often have one or more venture capital or angel investors on their boards with expertise on valuation matters. For this reason, many companies at this stage may elect to begin taking advantage of the written report safe harbor and rely on their financially oriented board members to provide the written report. However, many other companies at this stage...
will consider themselves so early in their life cycles that going to the effort of creating a written report each time options are granted may not be justified by what they may perceive as a relatively low risk.

For early stage companies that elect not to pursue the written report safe harbor, we recommend that the board of directors consider all the factors outlined in the proposed regulations in determining the common stock value each time options are granted, and that the minutes include as an attachment a summary of the factors the board considered in establishing its valuation for the company and for the common shareholders. In addition to the IRS factors, other relevant factors would include post-money value after the company's most recent round of angel or venture financing combined with the liquidation model showing the proceeds to common stock if the company were sold at that price. Many or all of the factors that become relevant for more mature companies (e.g., present value of anticipated cash flows, market value of similar companies) will likely not apply to, or provide meaningful information for determining the value of, a company at the earliest stages. However, while the most recent preferred stock price remains a significant factor in determining the value of a company's common stock, companies for which other material valuation information is available should consider that information, as well as any of the factors for the written report safe harbor that are applicable.

**Middle Stage Private Companies.** Once a company has begun to execute on its business plan and produce revenues, we believe it makes more sense for them to consider moving fully to the written report safe harbor, if they are not using it already. Companies at this stage will typically have more financial and valuation expertise on the board and in management than an early stage company, including at least one if not multiple VCs and an experienced CFO or VP Finance. Middle stage companies often also have greater resources, larger employee bases and more at stake in getting correct the Section 409A and accounting aspects of option pricing.

We expect that, as middle stage companies that have not previously used a safe harbor approach begin transitioning from board-approved option pricing (based on an analysis of IRS factors) to an actual written report each time options are granted, they may consider reducing the frequency of option grants from monthly to perhaps quarterly in order to minimize the burden of the written reports. We would expect the written report to include an assessment of the IRS factors described above and other relevant factors, which could include the company's post-money valuation based on the last round of financing, acquisition potential, venture capital or other financing prospects, industry growth projections, stage of execution on business plan, potential for joint ventures or other partnering opportunities, current and projected cash needs and management team experience.

**Large or Later-Stage Private Companies.** As companies continue to mature in their life cycles and become more established, there will come a point at which the 12-month liquidity event constraint of the written report safe harbor will begin to create a problem. Companies that have realistic chances of doing an IPO within 12 months, even without specific plans to do so, or that have an idea that the next year might be the right time to explore a sale of the company, should seriously consider obtaining an independent third party appraisal to establish valuation. Getting a new appraisal each time options are granted may not be practical, but companies may want to explore alternative compliance ideas. The further along a company gets, the more we would expect them to obtain at least annual independent appraisals in response to pressure from lenders, auditors and independent board members. These companies will likely also arrange with their independent valuation firm for periodic updates or bring-down valuations to facilitate periodic stock option grants.

**All Private Companies Should Consider Granting Stock Options Only Periodically (to the Extent Practicable).** Because establishing private company stock valuation will involve a more rigorous process, and because
an inaccurate valuation has potentially severe consequences, we expect private companies to alter their stock option grant practices. Companies can better administer a stock compensation program under these new requirements if the company grants options less frequently than has historically been typical for venture backed companies. For example, granting options quarterly, following an independent valuation, a periodic update or bring-down of that valuation or a valuation analysis by management or a board member, rather than granting options whenever a new employee is hired or even on a monthly basis, would make the process of compliance more manageable. A less frequent grant approach would allow the board to consider events and applicable changes in the company and its industry since the last valuation and more accurately determine the current value of the company’s stock.

"To-Dos" - Transition Rules Require Good Faith Compliance Through 2006. Section 409A generally applies to deferred compensation that is earned or becomes vested after December 31, 2004. It does not apply to deferrals earned and vested before 2005 unless the plan or agreement under which the deferral is made is materially modified after October 3, 2004. Generally a stock compensation arrangement that vests after December 31, 2004 will not be treated as violating the requirements of Section 409A if the company administers the arrangement in good faith compliance with Notice 2005-1 and Section 409A through 2006 and amends it by December 31, 2006 to conform its terms to the requirements of Section 409A and any related guidance (e.g., by modifying discounted stock options to eliminate the discount).

Welcome Guidance for Pre-2005 Stock Option Valuation. IRS Notice 2006-4 generally provides that, until further guidance is issued, where there was a good faith attempt to set the exercise price for stock options granted before January 1, 2005 (the cut-off date for unvested options covered by Section 409A) at a price not less than the fair market value of the underlying stock on the grant date, the IRS will treat the exercise price as not discounted for purposes of determining whether Section 409A covers the stock options.

Additional Information


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