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Internal Revenue Code s. 409A and Independent Appraisals

Summary

The IRS has announced proposed regulations which will radically change the tax treatment of stock options issued by private companies.[1] Stock options which are issued at less than the fair market value of the underlying stock can trigger immediate adverse tax consequences for both the issuing company and the option holder:

- Taxation at ordinary income rates at the time of vesting (not upon exercise) for the option holder;
- Required payment of withholding and employment taxes by the issuing company during vesting; and
- An extra tax of 20%, plus interest, imposed on the option holder.

The only way to protect companies and employees from these adverse consequences is to ensure that options are issued at fair market value ("FMV"). And the easiest way to establish FMV is to obtain an independent appraisal.

Pagemill Partners has experienced investment bankers who understand emerging and middle-market technology companies. Pagemill Partners is continually offering merger and acquisition services or raising funds for technology companies, so it has the market knowledge to rapidly provide an expert valuation which will anchor an issuing company in the IRS "safe harbor."

Background to the Changes

The American Jobs Creation Act of 2004[2] contained a large number of tax cuts for business. To generate offsetting revenue,[3] Congress altered the regulations governing deferred compensation for the first time in more than 25 years. The intention was to close loopholes and capture more taxable income. However unless an issuing company structures its option plan appropriately, its stock options can get caught in the net.

Previously, private companies routinely issued common stock options to employees and others at a discount – sometimes a substantial discount – relative

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[1] The regulations are not yet final, but they are retroactive to January 1, 2005, and taxpayers should act in accordance with the proposed regulations as evidence of "good faith compliance." Internal Revenue Bulletin, 2005-43, October, 24, 2005, Regulation 158080-04, "Notice of Proposed Rulemaking, Application of s. 409A to Nonqualified Deferred Compensation Plans," (xi)(B). http://www.irs.gov/irb/2005-43_IRB/ar09.html#d0e1742 Hereafter called "Notice."

[2] American Jobs Creation Act of 2004 (PL 108-357).

[3] The bill was "scored" by the Congressional Budget Office to bring in $145 billion of annual revenue, making it revenue neutral. http://tax.cchgroup.com/tax-briefings/2004-Jobs-Creation-Act.pdf.

to the price paid by investors for preferred stock. Often the common stock was valued as a fixed fraction of the value of the preferred stock, with the discount justified by the different rights of preferred and common stock. As a typical company matured and approached an initial public offering, the discount was reduced, especially after the Securities and Exchange Commission moved in the late 1990s to force companies to report substantial compensation expense for such “cheap stock.”[4]

The practice of issuing stock options at a discount to FMV now will be penalized by the Jobs Creation Act and section 409A of the Internal Revenue Code. Congress specified that options priced at or above FMV will not be subject to the new tax treatment.[5] However, any option issued with an exercise price less than the FMV will be treated as a “nonqualified deferred compensation arrangement.”[6] And s. 409A was designed to tighten the taxation of nonqualified deferred compensation (basically, any plan that is not “qualified,” for example, a s. 457 defined benefit or s. 401K defined contribution plan) by currently taxing income that historically was deferred.

Adverse Consequences

As mentioned, there are adverse consequences to both the issuing company and the individual receiving the stock option if the option price is less than FMV at the time of issuance. For the issuing company, these include:

- Having to calculate and report gains on Form W-2 or Form 1099 as the option vests (not upon exercise);[7] and
- Having to withhold income and employment taxes (likely having to deduct taxes from current income because there are no realized gains yet).

For the option holder, these include:

- Having to pay taxes from current income for unrealized option gains; and
- Having to pay a 20% penalty, plus interest, for under reporting.

Under these circumstances, issuing companies could see the traditional advantages of stock options evaporate, especially if employees are forced to pay tax for gains they may never realize. Options would become a liability, not an incentive. In addition, it is likely that venture investors and corporate buyers are going to require a representation about historical compliance with s. 409A in future investment and acquisition agreements.

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[4] "FASB Concludes Deliberations on Stock Compensation Issues," December 4, 1998; "FASB Releases Proposed Interpretation on Stock Compensation," March 31, 1999 (press releases available on FASB's Web site, www.fasb.org). "`Cheap' Stock Options Targeted by the SEC," *The San Jose Mercury News*, September 22, 1997.

[5] Notice (ii)(2)(c)(1). Also, H.R. Conf. Rep. No. 108-755, at 735 (2004).

[6] Notice (ii)(2)(c)(1).

[7] Internal Revenue Service, “Guidance Under s. 409A of the Internal Revenue Code,” Notice 2005-1, paragraph F, “Application of Information Reporting and Wage Withholding Requirements.” http://www.irs.gov/pub/irs-drop/n-05-01.pdf.

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Safe Harbor

Fortunately, there is a simple way to avoid these adverse consequences. Under s. 409A, any option issued at the FMV of the underlying stock will not be subjected to this punitive treatment.

The IRS also has provided guidance about establishing FMV. If an issuing company uses one of three specified valuation methods, then in any later dispute the IRS must prove both that the option price was less than the FMV and that the issuing company's use of the method was "grossly unreasonable" (a heavy burden of proof for the IRS).[8] The three methods are:

- Independent appraisal – a valuation performed by a qualified independent appraiser using traditional valuation methodologies.[9]
- Illiquid start-up – an internal valuation meeting five requirements (1. a written report; 2. taking into account listed "general valuation factors"[10]; 3. performed by a person with significant knowledge and experience or training in similar valuations; 4. the stock is not subject to a put or call, other than a right of first refusal; and 5. the company does not anticipate an IPO or sale within 12 months).[11]
- Binding formula – a formula established in a buy-sell agreement and used in all other agreements and filings.[12]

The third alternative is very limiting and will not be attractive to most companies. The second alternative will pose challenges for many early stage companies because it requires that a member of management or the board of directors be a person "with significant knowledge and experience or training in similar valuations."[13] And, even if a member of management or the board of directors is a financial executive or venture capitalist who fits the profile, he or she may not want to do the work and/or take the risk of signing the written report. The easiest and safest route is the first alternative – obtaining an independent appraisal.

Independent Appraisal

According to IRS rules, an outside appraisal must come from a firm which is qualified and independent. And the appraisal must be current, in writing, and take into account general valuation factors.[14]

[8] Notice, (iv)(B)(2).
[9] Notice, (iv)(B)(2)(i).
[10] See p. 4, below.
[11] Notice, (iv)(B)(2)(iiii).
[12] Notice, (iv)(B)(2)(ii).
[13] Notice, (iv)(B)(2)(iii).
[14] IRC s. 401(a)(28)(c) and regulations.

To be qualified, the firm must demonstrate that it has relevant experience in performing such valuations for companies of that size and in that industry and must present these qualifications in writing. To be independent, the firm must not be affiliated with the company being valued. In practice, this likely will mean that the appraisal will have to be prepared by a firm, not an individual, because the test for independence is that the fee for the appraisal is less than 1% of annual income for the appraiser and very few sole practitioners will perform enough appraisals in a year to pass this test.[15]

The appraisal can be used for 12 months; however, it must be updated if there is a significant event such as an outside investment, an IPO or sale of the company, resolution of material litigation, or issuance of an important patent. (Most issuing companies will want to obtain updated interim appraisals at regular intervals during the 12 month period, just to be safe, even if there is not a significant change.) The report must be in writing and take into account general valuation factors, including:

- The value of tangible and intangible assets;
- The present value of cash flows;
- The public trading price and/or private sale price of comparable companies; and
- Any control premium or discount for lack of marketability.[16]

Action Items for Issuing Companies

Issuing companies need to consult with their tax and legal advisors about whether their current stock option plans and valuation procedures meet the requirements of s. 409A. Even stock options issued before 2005 are subject to the new rules if they are not yet fully vested.[17] If outstanding stock options are priced below FMV, the IRS will allow cancellation and reissuance of existing options (including arrangements to make up the "lost discount") until December 31, 2005, so long as the new arrangements are at FMV.[18] New stock option plans will need to conform to s. 409A and new option grants must be made at FMV to avoid withholding and additional taxation.

The IRS is moving aggressively to implement these rules and has issued "Audit Guidelines" for its staff.[19] For both existing plans (including cancellation

[15] IRC s. 170(a)(13)(c)(5) defines a "qualified appraiser" by excluding "any person whose relationship … would cause a reasonable person to question the independence of such appraiser." And DOL regulations for ERISA s. 408(a) state: "If an entity is to serve as … Qualified Independent Appraiser, less than 1% of that firm's annual income … may come from the party in interest." http://www.umet-vets.dol.gov/ebsa/publications/exemption_procedures.html
[16] Notice, (iv)(B)(1).
[17] Notice, "Application of s. 409A to Nonqualified Deferred Compensation Plans, Effective dates – earned and vested amounts."
[18] Notice, s. H, "Substitutions of Non-discounted Options … for Discounted Options."
[19] Nonqualified Deferred Compensation Audit Techniques Guide (02-2005) http://www.irs.gov/businesses/corporations/article/0,,id=134878,00.html.

and reissuance) and new plans, it is advisable to seek the safe harbor by having a qualified independent appraiser prepare a written valuation report.

Pagemill Partners

Pagemill Partners can prepare an independent appraisal and deliver a written report rapidly. Because it does not have the overhead expense of other investment banks, it can do so for a reasonable fee. Pagemill Partners also can provide interim updates to coincide with board meetings and option issuance. If necessary, Pagemill Partners is prepared to support its valuation in any subsequent interaction with the IRS, including expert testimony.

In a typical valuation, Pagemill Partners establishes the value of a client company by examining:

- Financial data for comparable publicly traded companies;
- Financial terms of mergers for comparable companies;
- Financial terms of private financings for comparable companies; and
- Discounted cash flows.

Pagemill Partners then looks at the individual position of a client company and considers special factors such as tangible or intangible assets, the size of the liquidation preferences for preferred stock, the presence of a control stake or blocking rights, and similar things. All of this is then evaluated by a team of experienced professionals to arrive at the final value.

Pagemill Partners provides financial advisory services, including mergers and acquisitions, private placements, and specialized financial studies to emerging and middle market technology companies. The firm's vast knowledge of investment banking and comprehensive understanding of technology markets, management teams, and operations enables it to assist clients in the software and services, communications, semiconductor, security, and other technology industries. Pagemill Partners leverages its long standing relationships with a broad network of investors and organizations to help clients accelerate growth and leadership globally. Headquartered in Palo Alto, Calif., Pagemill Partners' recent transactions include: Bloglines' acquisition by Ask Jeeves; raising $25 million for Shop.com; and Tarantella's acquisition by Sun Microsystems.

For a proposal or for additional information, contact
Jim Timmins, Managing Director, at 650.233.4021 or jtimmins@pmib.com.
More information about Pagemill Partners is available at www.pmib.com.

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