THE IMPACT OF SECTION 409A ON OPTION GRANTS

April 2009

Background

Section 409A of the Internal Revenue Code, enacted on October 22, 2004, was intended to reduce the ability of participants in nonqualified deferred compensation plans to control at what time they receive (and are taxed on) their compensation. Section 409A generally applies to all plans where compensation vests and becomes taxable in two different years. Since options often vest and become taxable in two different years, they often would be subject to Section 409A. But Section 409A does not apply to:

- Incentive stock options, or "ISOs," and
- Nonstatutory stock options ("NSOs") to purchase Common Stock at an exercise price that is at least equal to the fair market value of the underlying stock at the time of grant.[1]

Therefore, the valuation of the Common Stock is critical.

If Section 409A applies to an option, then the terms of the option must limit exercises to certain times or window periods specified at the time of grant.[2] Otherwise, the optionee is taxable at the end of each year in which an increment of the option vests. The taxable amount is equal to the option spread with respect to the portion of the option that vested during the year, plus a 20% penalty tax and interest. The spread is measured at the end of the year in which the option vested unless it was exercised during the year, in which event the option spread is measured at the time of exercise. In general, the employer must withhold on the option spread—but not the penalty tax—at the end of each year in which all or part of the option vests. The recognition of taxable income, along with the withholding obligation, ends at the end of the year in which the option is exercised (provided that a Section 83(b) election is filed in the case of unvested shares).

Some States impose additional excise taxes on Section 409A income. For example, California imposes its own 20% tax in addition to all other federal and state taxes.

Final regulations under Section 409A were issued the IRS on April 10, 2007, and became effective on January 1, 2009. Although the final regulations are 397 pages long (including a lengthy preamble), they failed to address a number of issues. Some of those issues are covered in proposed regulations published by the IRS on December 8, 2008, and in several IRS Notices. This summary covers only a small part of the topics addressed by the IRS, and it necessarily simplifies some very complex rules. Therefore, please contact one of the Gunderson Dettmer attorneys if you have specific questions or concerns regarding Section 409A.

ISOs

As noted above, Section 409A does not apply to ISOs. However, Section 422 of the Internal Revenue Code sets forth rules that govern the qualification of ISOs. Among other things, the exercise price of an ISO may not be lower than 100% of the fair market value of the underlying stock at the time of grant. Section 422 provides that "an attempt, made in good faith,"

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[1] Special rules apply to the grant of NSOs to purchase Preferred Stock.

[2] The permissible times or window periods include one or more of (a) the date(s) when the option vests, (b) the date of the optionee's separation from service, (c) the date of the optionee's death or disability, (d) a specific calendar year or (e) a change in control of the employer. In general, the option could become exercisable at any time in the calendar year in which one of these events occurs (or within the first 2½ months of the next year). An IPO is not a permissible exercise trigger.

to value the Common Stock is sufficient for this purpose, even if the valuation later turns out to be incorrect. The IRS regulations interpreting the "good faith" rule create a safe harbor if the valuation is based upon an average of the fair market values set forth in the opinions of completely independent and well-qualified experts. The opinions may take into consideration the optionee's status as a majority or minority stockholder.

The IRS historically has not emphasized enforcement of the valuation rules applicable to ISOs. This was likely due to the fact that disqualifying an ISO and turning it into an NSO often would not produce additional revenue for the government, since employers are entitled to a deduction equal to the ordinary income that optionees must recognize upon exercising NSOs. Now, NSOs that fail to comply with Section 409A could generate substantial revenue for the Government. Therefore, it is advisable to use care when valuing Common Stock, regardless of whether the options being granted are ISOs or NSOs.

General Valuation Guidelines

As previously mentioned, NSOs are also exempt from Section 409A if the exercise price is at least equal to the fair market value of the Common Stock at the time of grant. The final IRS regulations contain extensive guidance on the methodology for valuing Common Stock. They include mandatory guidelines that will apply in all situations. In addition, the regulations describe "safe harbors" that companies may wish to use on a voluntary basis.

Under the general guidelines, all valuation methods must consider the following factors (to the extent that they are applicable in a particular case):

- The value of tangible and intangible assets of the corporation,
- The present value of anticipated future cash flows of the corporation,
- The market value of a corporation engaged in a substantially similar business, if that market value can be readily determined through objective means (such as trading prices or arm's length private transactions),
- Recent arm's length transactions involving the company's Common Stock, such as a repurchase of shares from a founder or a sale of shares by an employee to a third party,
- Control premiums, and
- Discounts for lack of marketability.

In addition, the regulations provide that all valuation methods must take into consideration all available information that is material to the value of the corporation. A prior valuation may no longer be used if it fails to reflect important new developments, such as the resolution of material litigation or the issuance of a patent.

Finally, the company may not rely on any valuation for more than 12 months. In other words, valuations must be updated after the earlier of (a) the occurrence of material new developments or (b) 12 months after the date of the prior valuation. As a result, some companies are granting options less frequently than in the past, in order to reduce the need for costly and time-consuming updates.

Valuation "Safe Harbors"

In addition to prescribing general valuation guidelines, the final IRS regulations create a presumption that certain "safe harbor" valuation methods will result in a reasonable valuation. The following two safe harbors are most commonly used:

1. **Independent Appraisal**. A valuation will be presumed to meet the requirements of Section 409A if it was performed by an outside appraiser who is independent of the company.[3] A number of valuation firms are prepared to provide reports intended to comply with this safe harbor. The fees charged by reputable firms for the initial

[3] In the case of a later-stage company, the company's independent auditors may require such a valuation in any event.

report appear to range from about $5,000 to $35,000. Updates should be considerably less expensive than the initial reports.

2. **Inside Valuation**. Under the regulations, a valuation will also be presumed to meet the requirements of Section 409A if it was prepared by someone who is not independent of the company but who is qualified to perform such a valuation based on "significant knowledge, experience, education, or training." The regulations define "significant experience" to mean at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or comparable experience in the company's industry. The following prerequisites apply to this safe harbor:

   - The safe harbor is available only if the company and its predecessors have been conducting business for less than 10 years.
   - The safe harbor is not available if the Common Stock is subject to a right of repurchase that does not lapse over time, *i.e.* a right of repurchase that applies even to vested shares.
   - The regulations provide that the safe harbor may be used only if neither the company nor the optionee "may reasonably anticipate" that the company will be acquired within 90 days or go public within 180 days.

   The valuation report required for the second safe harbor could be prepared and approved by one or more Board members or by the CFO, if they have the required qualifications.[4] It could also be prepared by a third party (such as a consultant or a venture fund CFO) who has the required knowledge and experience or training. Since the third party would not provide a formal opinion, the cost should be lower than the cost of an independent appraisal.

Using a "Safe Harbor"

A company may continue to grant options without taking advantage of a safe harbor, as long as (a) the general valuation guidelines described above are observed and (b) the company is prepared to accept the burden of proving to the IRS that the valuation was reasonable. For example, a new start-up may not use any safe harbor, merely complying with the general valuation guidelines. Once the company has secured its first round of outside financing and one or more experienced directors have joined the Board, it may adopt the "inside valuation" safe harbor. Finally, after a Series B investment round, the company may switch to the "independent appraisal" safe harbor. In this manner, a single company could use multiple approaches as it grows.

Aside from possible enforcement efforts by the IRS, any company that may be acquired should consider how the potential acquirers will view its valuation methodology. Our recent experience has been that public companies are reluctant to assume private-company options unless they were granted in reliance on the "independent appraisal" safe harbor. Moreover, the acquirers tend to construe the "independent appraisal" safe harbor very conservatively. Even if options are not assumed, the target company will probably be asked to make a representation in the merger agreement (backed by the escrow fund) to the effect that there is no Section 409A exposure. Relying on a safe harbor will make the representation more palatable to the target's investors.

Modification or Extension of Existing Options

If an existing option is "modified," the modification is treated as the grant of a new option. This means that the exercise price cannot be lower than the fair market value of the Common Stock on the date of the modification. Otherwise, Section 409A becomes applicable to the option on the date of the modification.

The definition of "modification" remains unclear in many situations. However, the regulations provide the following guidance:

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[4] It has been suggested that the individual(s) approving the valuation report may have personal liability, if the report is found to be wrong and optionees are exposed to additional tax under Section 409A.

- A direct or indirect reduction of the exercise price is a modification. (Adding the ability to pay the exercise price with a no-interest note would be an example of an indirect reduction of the purchase price.)
- An acceleration of vesting is not a modification for purposes of Section 409A.
- An extension of the option term is discussed below.

Other changes in the terms of an option must be examined on a case-by-case basis.

In principle, if the exercise period (term) of an NSO is extended, then the option becomes subject to Section 409A, retroactive to the date of grant. However, the final regulations offer two exemptions from this rule, with the result that it will rarely apply.[5] The exemptions are as follows:

- An option may be extended to the end of its maximum term (but not later than the 10th anniversary of the date of grant). For example, assume that an optionee holds an option with a 10-year term that normally would expire three months after his employment terminates. Furthermore, assume that the optionee is laid off and his exercise period is extended from three months to two years in exchange for a release of claims. This extension does not subject the option to Section 409A, as long as at least two years remain in the original 10-year term.
- An option may be extended without any restrictions, if it is out of the money at the time of the extension. Such an extension is treated as the grant of a new option.

Direct Issuances of Shares

Direct issuances of stock are exempt from Section 409A. This applies to founders' stock and to direct issuances to employees, directors or consultants. While the IRS so far has declined to address the question, it appears that the early exercise of an option (*i.e.* an exercise to purchase unvested shares) and the filing of a Section 83(b) election should avoid the application of Section 409A for subsequent periods.

Effective Dates of Option Rules

The effective date and transition rules articulated in the IRS guidance are exceedingly complex and, in most cases, do not directly deal with options. But we feel reasonably confident that these rules may be applied to options as follows:

- Section 409A does not apply to an option if it (a) was granted on or before October 3, 2004, and (b) vested on or before December 31, 2004.
- Unless an exemption applies (see above), Section 409A applies to options that vest on or after January 1, 2005. If an option vests in installments, Section 409A would apply only to those installments that vest on or after January 1, 2005.
- In certain circumstances, an option may be amended so that it either (a) qualifies for an exemption from Section 409A, as described above, or (b) complies with Section 409A. For example, if an option provides for an exercise price below 100% of fair market value at the time of grant, it may be possible to increase the exercise price. The optionee's written consent would generally be required, but the optionee would probably prefer the higher exercise price over the tax consequences engendered by Section 409A. However, the IRS has severely limited the availability of this relief in years after 2008.
- Under IRS Notice 2006-4, NSOs granted before 2005 will be deemed to satisfy the "100% of fair market value" requirement of Section 409A if the "good faith" standard applicable to ISOs is met. For NSOs granted after 2004 but before 2008, the "100% of fair market value" requirement will be deemed to be satisfied as long as a reasonable method was used to value the stock. What is considered "reasonable" presumably depends on the amount of IRS guidance that was available at the time of grant.

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[5] However, an extension will disqualify an in-the-money ISO and turn it into an NSO. Since it is not known on the date of grant if an ISO will later be disqualified, care should be taken to structure ISOs to be exempt from Section 409A. In addition, an extension will often trigger accounting issues under FAS 123R.

If an option is "grandfathered" under the rules above, the option could nevertheless lose its exempt status if it is modified after that date. Please contact a Gunderson Dettmer attorney if you have questions regarding the status of existing options under Section 409A.

A Quick Word on Severance Benefits

As noted above, Section 409A generally covers all plans and agreements under which compensation vests and becomes taxable in two different calendar years. Under this principle, Section 409A applies to severance benefits, if the payments "vest" in one year but the actual distributions stretch into subsequent years. For this purpose, "vesting" is deemed to occur when employment terminates, or even earlier if the employee may qualify for the payments by resigning (as opposed to being actually or constructively discharged). The IRS regulations confirm that severance benefits may be subject to Section 409A.

Fortunately, the regulations also offer a "safe harbor" for severance pay. If each of the following requirements is satisfied, the severance pay generally is exempt from Section 409A:

- The employment termination that triggers the severance pay must be involuntary. This includes a resignation for "good reason," if certain requirements spelled out in the regulations are satisfied. (Typically, "good reason" means a material pay cut, a material demotion or a material involuntary relocation.)
- The employee cannot provide substantial consulting services to the company after the employment termination.
- All severance payments must be completed by the end of the second full calendar year after the year of the termination.
- The exemption is available only for amounts up to the smaller of (a) $490,000 or (b) two times the employee's total compensation for the calendar year preceding the year of the termination. (The $490,000 amount is indexed for inflation.)

The implications of Section 409A must be considered when offer letters and employment agreements with severance pay provisions are prepared. They also must be considered whenever separation agreements and releases are negotiated with departing employees.[6] Please consult a Gunderson Dettmer attorney if you have questions about the applicable rules.

A Note on Salary Deferrals

Often the founder of a start- up company will voluntarily accept a below-market salary until the company obtains outside financing. The founder may want to create a legal obligation on behalf of the company to pay the missed salary at a specified future date. This obligation can take a variety of forms, including a salary deferral or a performance bonus (payable, say, when a financing closes).

Salary deferrals are subject to extremely complex rules regarding the time when a deferral election must be made and the time(s) when the deferred salary may be paid. In addition, if a deferral election is made, the deferred salary may not be paid sooner than the time provided in the election. Any change in the election to further delay the payment date is subject to additional rules, which generally mandate at least a five-year delay. If a deferral election is not properly structured or payment of a deferred amount is improperly accelerated or further deferred, it will result in the immediate inclusion of the supposedly deferred amounts in income plus a 20% excise tax. For this reason, counsel should be contacted in advance of commencing any salary deferrals.

We continue to advise that founders pay themselves at least the minimum amount necessary to qualify as "exempt" employees under federal and state law. In California, this amount is $33,280 per year in 2008 and subsequent years.

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[6] The regulations make it clear that Section 409A cannot be avoided by disguising severance pay as a fee for minimal "consulting services."

Gunderson Dettmer's lawyers are available to assist in addressing questions you may have regarding the issues discussed in this Alert. Please contact the Gunderson Dettmer attorney with whom you regularly work. Contact information for our attorneys can be found at www.gunder.com.

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