LAW·FLASH
A CLIENT ALERT FROM THE EMPLOYEE BENEFITS PRACTICE
Morgan Lewis
COUNSELORS AT LAW
www.morganlewis.com

IRS Clarifies Valuation Rule For Options and SARs Under Section 409A

December 28, 2005

In a welcome gesture of holiday cheer, the IRS issued Notice 2006-4 on December 23, 2005 and clarified that the highly controversial valuation rules for options and stock appreciation rights (SARs) set forth in proposed regulations under section 409A of the Internal Revenue Code (Code) will become effective prospectively, when and if contained in final regulations.

As a practical matter, this clarification will allow privately held employers to continue the current practice of having the board of directors determine the fair market value of the stock based on a reasonable valuation method, when setting the exercise price for stock options and SARs. Privately held employers will be able to avoid, at least until 2007, the cost and administrative inconvenience of obtaining a third party valuation for section 409A purposes (although, depending on the circumstances, a third party valuation may still be advisable for accounting or other reasons).

For options and SARs granted in 2005 and 2006 by privately held companies, the board of directors should document the board's determination of the fair market value of the stock as of the date of grant, and the reasonable valuation method used to determine fair market value.

Notice 2006-4

Notice 2006-4 takes the following action:

- As to non-qualified stock options (NQSOs) and SARs granted prior to January 1, 2005, the fair market value rule under section 409A of the Code will be deemed to be met if the incentive stock option (ISO) valuation standard under section 422 of the Code has been met (i.e., if a good faith effort was made to value the stock at fair market value).

- As to NQSOs and SARs granted on or after January 1, 2005 and prior to the effective date of the final regulations under section 409A (which is expected to be January 1, 2007), the fair market value rule under section 409A will be deemed to be met if the valuation methodology authorized under IRS Notice 2005-1 is met. Notice 2005-1 states that "any reasonable valuation method" may be used to establish fair market value. In most cases, a valuation procedure meeting the ISO standards should also meet the standards of Notice 2005-1. However, given the effort made by the IRS in Notice 2006-4 to distinguish pre-2005 methodologies from post-2004 methodologies, it is likely that post-2004 grants will be viewed as subject to a stricter standard than pre-2005 grants.

Background

As is now well known, section 409A was added to the Code late in 2004 and adds a variety of new restrictions on deferred compensation arrangements. Those restrictions principally relate to the timing of deferral and distribution elections, the specification of permissible distribution events and a prohibition on acceleration of distributions (subject to limited exceptions). The new rules apply, as a general matter, to deferrals made in 2005 and to amounts deferred but not yet vested prior to year end 2004. The new rules are enforced not only by current income tax but also by a 20% penalty tax and a potential incremental interest charge, each to be borne by the individual service provider.

The new rules apply in a surprisingly broad manner to arrangements not previously considered deferred compensation, such as severance, continuation of benefits and perquisites after termination of employment and, most relevant to the current discussion, non-qualified stock options (NQSOs) and SARs if issued at a discount from fair market value.

This new treatment of discounted NQSOs or SARs as a type of deferred compensation under section 409A of the Code places considerably greater importance on establishing that NQSOs and SARs are issued using a fair market value methodology that will withstand IRS scrutiny, especially in the context of a private company issuer. Under prior law, granting NQSOs or SARs at a discount simply increased the amount of ordinary income to be recognized on exercise, and, given the general matching of the amount and timing of the service provider's income inclusion and the service recipient's deduction, the issue did not seem to warrant IRS audit scrutiny. With the introduction of the 20% penalty and incremental interest rules under section 409A of the Code, the stakes have been raised considerably.

In addition, although the Treasury guidance has not yet made this point officially, a discounted stock option or SAR may be subject to an even greater infirmity: conversion of the entire amount of gain in the option or SAR to ordinary income subject to the 20% penalty tax when the option or SAR first vests (even if not exercised), and, as the stock price further appreciates, in each year thereafter while the option or SAR remains extant. This revolutionary approach to the taxation of discounted NQSOs and SARs, if a correct interpretation of section 409A of the Code, will place a real premium on setting the exercise price of NQSOs and the base price for SARs using a methodology that will be accepted by the IRS as determining an acceptable measure of fair market value.

The proposed regulations under section 409A of the Code highlight the distinction between ISOs and stock grants on the one hand, and NQSOs and SARs, on the other. ISOs and stock grants are outside the scope of section 409A, and many issuers of ISOs and stock grants may continue to use a good faith reasonable valuation methodology in determining the stock price. However, the proposed regulations (which could perhaps be viewed as reflecting a deep suspicion on the part of Treasury and the IRS as to private company valuation practices) take a much stricter approach to NQSOs and SARs.

Stock Valuation Under the Proposed Regulations

Under the proposed regulations, a NQSO or SAR will qualify for an exemption from section 409A only if the exercise price or base price is at least equal to the fair market value of the underlying stock on the grant date, based on standards set forth in the regulations.

For stock readily tradable on an established securities market, fair market value may generally be determined on the basis of actual transactions in the stock in the applicable market.

For stock not readily tradable on an established securities market, the proposed regulations set forth valuation factors that should be taken into account in determining fair market value. The proposed regulations provide three valuation methods that will be presumed to result in a reasonable valuation, unless the IRS can establish that the use of such method was grossly unreasonable:

- A valuation established by an independent appraisal that meets prescribed statutory standards under the Internal Revenue Code and applicable Treasury regulations. The appraised value must be as of a date not more than 12 months prior to the grant date.

- A valuation formula based on the tax principles governing the valuation of shares subject to non-lapse restrictions, provided the formula governs the subsequent transfer of any shares subject to the non-lapse restriction and is used for all compensatory and non-compensatory valuations of the stock, including regulatory filings, loan covenants and transactions involving the issuance or repurchase of the stock.

- For an illiquid stock not subject to any non-lapse put or call right or obligation (other than a first refusal right) and issued by a start-up corporation that has no trade or business which it has conducted for a period of 10 years or more, a written valuation report prepared by a person with significant knowledge and experience or training in performing similar valuations. The written valuation report must take into account the valuation factors specified in the proposed regulations. However, this valuation method will not be permissible if a change in control or initial public offering of the stock is reasonably anticipated to occur within the next 12 months.

As issued, the proposed regulations indicated that the new valuation rules would be applicable to all NQSOs and SARs subject to section 409A (essentially, any rights not earned and vested prior to January 1, 2005). Notice 2006-4 indicates that the proposed valuation rules will be effective prospectively, if and when the regulations are finalized.

If you have any questions or would like further information about section 409A, please contact any one of the following Morgan Lewis attorneys:

Chicago

Brian D. Hector	312.324.1160	bhector@morganlewis.com

Dallas

Riva T. Johnson	214.466.4107	rjohnson@morganlewis.com
Erin Turley	214.466.4108	eturley@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com

Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com
S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
Brian J. Dougherty	215.963.4833	bdougherty@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Joseph E. Ronan	215.963.5793	jronan@morganlewis.com
Steven D. Spencer	215.963.5714	sspencer@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com

Pittsburgh

John G. Ferreira	412.560.3350	jferreira@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

San Francisco

Mark H. Boxer	415.442.1695	mboxer@morganlewis.com
Eva P. McComas	415.442.1249	emccomas@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com

About Morgan, Lewis & Bockius LLP

Morgan Lewis is a global law firm with more than 1,200 lawyers in 19 offices located in Philadelphia, Washington, D.C., New York, Los Angeles, San Francisco, Miami, Pittsburgh, Princeton, Chicago, Palo Alto, Dallas, Harrisburg, Irvine, Boston, London, Paris, Brussels, Frankfurt and Tokyo. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend in emails, please see http://www.morganlewis.com/circular230.