# Section 409A Valuations and Stock Option Grants for Start-up Technology and Life Science Companies

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Federal, and at least one state's, tax laws make it especially important for companies granting stock options as compensation to set the exercise price of the underlying shares at or above the price that can be shown by a reasonable valuation method to be fair market value (FMV) at the time of grant. Employees, officers, directors and consultants who receive stock options with exercise prices that cannot be shown to be at or above the reasonably-determined FMV on the date of grant face immediate tax on vesting at a combined federal and state tax rate as high as 85% or more. Companies can establish a defensible FMV by using an IRS-approved valuation method. This shifts the burden from the company to prove the FMV determination is reasonable to the Internal Revenue Service to prove the FMV determination is unreasonable, reducing the likelihood of a successful challenge.

**High Taxes on Options with Below-FMV Exercise Prices.** Section 409A of the Internal Revenue Code (Code) requires the holder of an option having an exercise price below FMV at the time of grant to recognize taxable income equal to the spread between the exercise price and the FMV of shares as they vest. Thus, the optionholder will be taxed on income the optionholder does not actually receive, from shares that may not then even be saleable. Further, in addition to regular federal income and employment taxes, an additional 20%+ federal tax will apply. Certain states (for example, California) may have parallel statutes that in addition to their regular income and employment taxes can impose an additional 20%+ state tax. With respect to employees the company is required to withhold these taxes, and if it fails to do so, then it could be liable for these taxes plus penalties and interest. Although options that qualify as Incentive Stock Options (ISOs) under Section 422 of the Code are not technically subject to Section 409A (because by definition the exercise price of an ISO is at least equal to FMV at the time of grant), companies are advised to consider obtaining Section 409A valuations even when granting ISOs.

**Establishing a Reasonable Valuation Method.** Start-up company stock values are uncertain at best, but the high taxes optionholders potentially face, and potential withholding obligations imposed on companies, make it important to establish a defensible FMV at time time options are granted. Of Section 409A's three approved valuation methods, we describe two below that are generally pertinent for start-up and venture-backed companies. These valuations apply for up to 12 months unless there are intervening events that would reasonably and materially impact FMV.

**Independent Appraisal.** Most advanced venture-backed companies rely on professional appraisals to determine FMV and set the corresponding exercise prices of compensatory stock options. Section 409A allows FMV to be established presumptively by qualified independent valuation experts using methods recognized under the Code. Not surprisingly, independent appraisers are now in great demand and charge substantial fees for Section 409A valuations.

**Illiquid Start-up Appraisal.** A company that has been in existence less than 10 years and does not reasonably anticipate an IPO in the next 180 days or an acquisition in the next 90 days can rely on a valuation performed using Section 409A's enumerated valuation factors by a person (who can be a company employee) with significant knowledge and experience or training in performing similar valuations, if the stock being valued is not subject to put or call rights (other than a right of first refusal and repurchase rights on termination of service) and the valuation is memorialized in writing. The experience requirement may be met by having at least 5 years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry of the company.

**Restricted Stock as an Alternative to Section 409A.** Restricted stock is not subject to Section 409A, and so an alternative for early-stage companies is to sell or grant shares of unvested stock to eligible recipients. In this case, the recipients could file an election under Section 83(b) of the Code to be taxed in the year the election is made on the difference between the purchase price and the FMV of the shares on the date of grant (typically zero or a nominal amount), rather than being taxed on the difference between the purchase price and the FMV as the stock vests (when the stock hopefully is worth more).

Section 409A is another factor for start-up companies to consider when granting stock options. As a result, companies should seek legal counsel before promising or granting stock options to employees or other service providers.

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