Stock Options – Make Sure the Exercise Price is Right

By Ronald Dweck

Companies, particularly start ups, often issue stock options to incentivize and reward select employees. Properly structured stock options can be a great recruiting tool but a poorly structured stock option can have a nasty tax surprise for the employee. For tax purposes, it is important that the option have an exercise price that is equal to the fair market value of the stock at the time the option is issued. If the exercise price is less than fair market value, the option most likely will violate the rules of Internal Revenue Code Section 409A. You definitely want to avoid violating 409A! Otherwise, the option becomes a taxable event on vesting to the extent of the difference between the exercise price and the fair market value of the option, even though the option has not been exercised. Moreover, an additional penalty tax of 20% and interest are imposed on top of the ordinary income tax rate. These same rules would similarly apply to equity interests in limited liability companies.

The challenge is how to be sure that the option exercise price is equal to the fair market value of the stock at that time. The Section 409A regulations provide that fair market value may be determined through the "reasonable application of a reasonable valuation method." The regulations go on to recite various factors which should be considered. In practice, particularly for a start-up, it may be difficult to touch upon all of these factors. The regulations state that use of a method is not reasonable if it does not take into account all information relevant to value. More importantly, there is still a subjective element at work here. The stakes are high and coming up with what may seem a reasonable method may in fact be viewed differently by the IRS. Fortunately the regulations provide that certain valuations are "presumed" reasonable.

The safest way to go is to obtain a determination of fair market value from a qualified third party valuation firm. In such a case, the regulations allow the Company to rely on the valuation for a 12 month period, as long as nothing occurs during the period that would materially effect the valuation. Significantly, the valuation determined by the qualified firm is presumed to be reasonable. This means that the IRS would have to show that the valuation is grossly unreasonable.

Although getting such a valuation is clearly a safe harbor, an appraisal can be costly. In some cases the start up company is marshalling all of its resources to get started and does not want to incur the expense of an appraisal. The entrepreneur may also need to move quickly in attracting some of the initial key employees for the venture.

With regard to illiquid stock of a start-up corporation (in business less than 10 years), you can still get the benefit of the presumption as long as the determination is made by a "qualified person." That person does not have to be independent of the company. The valuation must be performed by a person that is qualified to value the company based on the person's "significant knowledge, experience, education or training." Would a reasonable person rely on such a person in deciding to buy or sell a stock? Significant experience generally means 5 years or more of relevant experience in business valuation, financial accounting, investment banking, or comparable experience in the Company's industry. There must be a written report and it must take into the account the factors set forth in the regulations. Sometimes the entrepreneur or the CFO can meet these requirements. However, if there is uncertainty about whether the person doing the valuation is qualified, then the only true safe harbor is to go with the qualified appraisal firm.

Stock options certainly have their place in the privately held company. However, their use is not without potential pitfalls, and options should only be issued with care. In particular, you need to be sure the exercise price is right, otherwise the employees you intend to reward may have a very unwelcome tax bite.

