EQUITY COMPENSATION
REPORT

News and ideas on sharing ownership through equity compensation

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Discounted Stock Options and Section 409A: A Cautionary Tale

Scott Usher, Bader Martin, P.S.

When stock options are intentionally or unintentionally offered at a discount—meaning with an exercise price less than fair market value on the date the options are granted—there are potentially serious tax consequences.

The Impact of Internal Revenue Code Section 409A

According to the IRS, discounted stock options fall under Section 409A of the Internal Revenue Code, which governs nonqualified deferred compensation plans—i.e., those nonqualified plans that provide for a *deferral of compensation*. Stock options with an exercise price that is equal to or above fair market value when granted are exempt from Section 409A, which was enacted in 2004 to limit flexibility in exercising rights to deferred compensation.

For those who run afoul of 409A's rules, the penalties are onerous. In general, the entire amount of compensation that has been deferred for the current and all previous tax years becomes taxable. That compensation is also subject to a 20% penalty, plus interest.

Many of the uncertainties in applying 409A have stemmed from the fact that the law doesn't specifically define the deferral of compensation. The IRS's rules and pronouncements have consistently interpreted the phrase to include discounted stock options. However, those rules were not tested in the courts—until this year, when the U.S. Court of Federal Claims granted a partial summary judgment in *Sutardja v. United States*. This ruling addresses various legal arguments with regard to the application of 409A, leaving the factual issue of whether the options were actually discounted to be determined at trial.

Consequences of the *Sutardja* Ruling

Sutardja is particularly significant because it is the first court ruling on the application of 409A to discounted stock options. As a result of *Sutardja*, we now have judicial affirmation of the following IRS positions:

- Discounted stock options are subject to Section 409A treatment as nonqualified deferred compensation.
- The date an option is granted determines when compensation is considered to be earned.
- The date an option vests, not the date it is exercised, determines when the recipient has a legally binding right to the compensation. The date it vests also establishes the time at which the option is no longer considered to have a substantial risk of forfeiture.
- The relevant period for applying the short-term deferral exclusion is not based on the date the options are actually exercised, but rather based on the period of time the options can be exercised under the terms of the plan.

The Cautionary Part of the Tale

The regulations under Section 409A occupy some 80 pages, which gives an indication of just how complicated it can be to either avoid it altogether or comply with its requirements. A few strategies can help.

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To Discount or Not to Discount: Fair Market Value

The application of Section 409A hinges on whether a stock option is discounted. If an option's exercise price is equal to the fair market value at the date the option is granted, the option is not discounted, and 409A does not apply.

If your company does not intend to discount the exercise price of its stock options, properly valuing them is central to avoiding the negative tax consequences of 409A. In the *Sutardja* case, the company intended to grant its stock options at fair market value. A combination of lack of oversight and poor execution led the company to grant those options at less than fair market value, which may cost the recipients of those options many millions of dollars.

Establishing fair market value can be problematic for startups and other privately held companies. Perhaps the safest way—and generally the most expensive way—to determine fair market value is to hire a qualified independent appraiser to perform the valuation. The appraisal must be performed within 12 months of the option transaction to satisfy the first of three valuation safe harbor rules under 409A. Under the second safe harbor rule, startup companies can use someone other than an independent appraiser to perform the valuation, as long as the person has the requisite knowledge and experience and the valuation satisfies other criteria under 409A. The third safe harbor involves the use of a formula to determine the valuation, as prescribed under Section 83 of the Internal Revenue Code.

Separate from the safe harbor approaches, companies are allowed to use *a reasonable application of a reasonable valuation method* based on specific factors identified in 409A. Unlike properly implemented safe harbor approaches, this valuation method is subject to challenge by the IRS, so it is critical to develop and save detailed documentation of the method used in determining the valuation.

Properly Establishing the Grant Date

In the *Sutardja* case, the company's compensation committee approved the option grant and established the options' fair market value at on same date. But the committee did not formally ratify that grant until nearly a month later, when the fair market value was higher.

The court determined that the date of ratification was the grant date, so the options were actually granted at a discounted price. By the time the company and recipient attempted to fix the error, it was too late as the options had been exercised.

Because of the impact that the grant date—and other elements of the process— can have on determining fair market value and general compliance with 409A rules, companies must develop and follow well-thought-out procedures governing the issuance of stock options.

Remedial Actions

It is always better to prevent compliance problems than to try and correct them later. But for those companies that find themselves out of compliance with 409A, the IRS has published guidance (in Notices 2008-113, 2010-6, and 2010-80) on certain allowed corrective actions.

Ultimately, whether the problem can be corrected—and, if so, how much relief is available—is as complex as the rest of 409A. It depends on a number of factors, including the nature of problem and the timing of the correction.

For stock options that were erroneously granted at less than fair market value, it may be possible to amend the option agreement to eliminate the discount. Generally, the exercise price can be increased to the fair market value (as of the grant date) in the year the options were granted. For option recipients who are not considered company insiders, that period is extended to include the following year. Under proposed regulations, it may also be possible to amend the option agreement before the year the options vest. Regardless, no corrective action is permitted for options that have been exercised.

Scott Usher is an MST, CPA, and senior manager in the tax practice at Bader Martin, P.S. This article is extracted from a slightly longer article originally published on the Startup Law Blog (www.startuplawblog.com) and provided to the NCEO.

EQUITY COMPENSATION REPORT

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National Center for Employee Ownership
1736 Franklin Street, 8th Floor
Oakland, CA 94612
Tel: 510-208-1300
www.nceo.org

Founders Stock in Startups

Margaret Steere

When starting a company, founders must (1) calculate the percentage and number of shares that will be allocated to each founder and (2) decide whether those shares will be subject to a vesting schedule.

The Founders Pie Calculator

Take the example of two individuals who have decided to start their own business as cofounders selling newly developed software. One of their first questions is how to divide the company stock between them. One useful approach is the Founders Pie Calculator, a practical guide developed by Frank Demmler for determining stock allocation among founders.

Rather than simply dividing stock equally among founders—a common but not necessarily recommended practice in the startup community—the calculator is a tool that quantifies the stock allocation decision-making process. It provides a mechanism for evaluating certain essential elements of a startup company: (1) idea, (2) domain expertise, (3) founder commitment, (4) business plan preparation, and (5) day-to-day responsibilities.

The first step in the calculation is to rate the relative importance of the five elements to the company on a scale of 1 to 10. Because this new company is based around a technology product and will likely seek venture capital funding, the elements of idea, domain expertise, and commitment are critical, while business plan preparation and day-to-day responsibilities carry slightly less weight (column 2 in the table below).

The next step is to rate the relative contributions of each founder to the elements. Founder 1 is a technologist, inventor, and "idea guy" who has quit his full-time job to start the new company and has numerous contacts in the technology world. His biggest contributions are to the idea, domain expertise, and commitment elements (column 3 in the table below).

Founder 2 is a marketer, business developer, and networker who is detail-oriented but not yet willing to leave his consulting job to commit exclusively to the new company. Consequently, his greatest contributions are in the areas of domain expertise, business plan preparation and day-to-day responsibilities (column 5 in the table below).

To calculate the weighted score for each founder on each of the elements, the relative value of each element to the company (column 2) is multiplied by the relative contribution of each founder (column 3 for Founder 1 and column 5 for Founder 2). The weighted points in columns 4 and 6 are then added together. The relative ownership percentage of each founder is his total weighted score as a percentage of the total weighted score of both founders.

Stepping back from the calculations themselves, a 57/43 split in the described scenario makes sense given the risk Founder 1 has taken and the fact that he has the expertise to develop the software the company plans to sell. Founder 2's contributions are important, too, but are not as central to the company's success until it seeks funding or hires employees—i.e., once there is a product to sell.

The Founders Pie Calculator is intended to serve as a guide for allocation decisions by creating a quantifiable scenario for calculating relative stock ownership. It is a flexible tool in that the elements evaluated may be different for any particular company or set of founders, and resulting percentages may be adjusted based on other factors, quantifiable or not. In addition, by forcing founders to have important conversations about their contributions and goals at the outset of the company's existence, using the Founders Pie Calculator may prevent misunderstandings down the road.

Restrictions on Founders Stock

In addition to careful consideration of stock allocations, it is advisable to attach a vesting schedule to Founders Stock to account for the possibility that an original founder might leave the business.

Provision can be made in the Founders Common Stock Purchase Agreement for a company option to purchase any unvested stock owned by a founder upon his or her exit. The vesting schedule will establish how quickly a founder's stock is released from the company's repurchase option.

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FOUNDERS PIE CALCULATOR

Element	Weight	F-1	F-1 Weighted	F-2	F-2 Weighted
Idea	9	10	90	5	45
Domain expertise	8	9	72	8	64
Commitment	7	10	70	4	28
B-plan	5	5	25	8	40
Responsibilities	4	4	16	7	28
Total weighted			273		205
% of total points			57%		43%

Short Bites

S Corporation Employee Owners Can't Dodge Taxes by Making Unreasonable Earnings Distributions

Employees who are also owners in S corporations can take income from the company both in the form of wages and distributions of earnings. Earnings distributions are not subject to payroll taxes nor are they subject to the potential additional 3.8% tax on net investment income (income from passive investment gains) that became subject to FICA and Medicare taxes in 2012 and that sole proprietors or partners might have to pay if some of their income were characterized as net investment income.

The IRS has taken the position that owner-employees in S corporations cannot avoid these taxes by paying themselves distributions in lieu of reasonable compensation for their services. In *David E. Watson, P.C. v. U.S.* , 668 F.3d 1008 (8th Cir. Feb, 21, 2012), for instance, the Eighth Circuit Court of Appeals denied an appeal of a lower court ruling that required Watson to pay additional taxes. Watson had deemed almost all the income from the one-person S corporation he owned as earnings distributions. The court said most of it should be recharacterized as compensation for services.

In IRS Fact Sheet 2008-25, the IRS indicated that in evaluating what reasonable compensation should be, it would look at training, experience, duties, bonuses, time working, and what other businesses pay for similar services. On the earnings side, it would look at what the history of earnings distributions has been and what is paid to nonemployee shareholders.

SEC Makes It Easier to Advertise for Investors in Entrepreneurial Companies

On July 10, the Securities and Exchange Commission issued final rules under the JOBS Act to allow both entrepreneurial companies and hedge funds to use general solicitations, such as advertising or blogs, to attract accredited investors (those with a net worth of at least $1 million, excluding their primary residence, or annual income of more than $200,000 in each of the previous two years). Under the rules, companies must use reasonable methods to verify that any investors are accredited. The rules include a non-exclusive list of these steps, but in general, the steps to verify that the purchasers are accredited investors would be:

> an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction. Under this principles-based approach, issuers would consider a number of factors when determining the reasonableness of the steps to verify that a purchaser is an accredited investor, such as:
>
> - the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
> - the amount and type of information that the issuer has about the purchaser; and
> - the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

The new rule was greeted by predictable enthusiasm from potential issuers and equally predictable concern from state regulators and investor watchdog groups concerned about fraud and excessive investment risk. In one case, for instance, a supposed beef jerky company attracted considerable investment—but there was no actual company.

Good articles on the rules can be found in the *Wall Street Journal* and the *New York Times.*

The Incentive Pay Asymmetry: Why You May Not Get What You Pay For

In a very good article A New Perspective on the Executive Compensation Debate in the June 2013 issue of *Workspan*, Scott Olsen of Pricewaterhouse Coopers discusses why incentive plans, including equity compensation, often deliver less than expected. The article is based on a survey of 1,100 executives in 43 companies by Olsen, but its findings would apply to any employee.

Olsen's basic finding was that executives tend to undervalue long–term incentives for six reasons:

- Risk aversion makes people prefer short-term bonuses even if the risk-adjusted value of a long-term incentive.
- Complexity and ambiguity in plan design may seem to create more precise alignment of goals and pay but can undermine confidence and motivation.
- People excessively discount long-term awards relative to their true economic value.
- People measure the value of their awards at least as much in terms of relative fairness (relative to other employees) as absolute value.
- People work for more than money.
- Recognition counts even absent monetary rewards.

When companies evaluate the costs of rewards, they use a rational economics model to calculate the present value of the reward that reflects the risks of the incentive being offered. But individuals look at incentives in a more complex way that takes into account anxieties, needs, and preferences that go beyond mere economic rationality.

To make plans to be more effective, Olsen argues that plans should be simpler and more predictable, more

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Short Bites

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geared to the specific preferences of employees, and to incorporate concepts of relative fairness and personal recognition.

Cases and Rulings

Phantom Carried Interest Plan Covered by ERISA If Delayed Till Termination: In *Bingham v. FIML Natural Resources LLC*, No. 1:13-cv-00167-CMA (D.C. Colo. June 18, 2013), a district court ruled that a phantom carried interest plan (a plan providing employees with a share of long-term profits of the LLC) that pays out at termination is a retirement plan covered by ERISA and must be litigated in federal courts. The case is a good example of general rule that any kind of deferred equity or equity-like plan that is designed by its terms to pay out at or after termination or retirement will generally be subject to ERISA, although plans can be exempted if they are limited only to a small number of employees.

Noncompete Clause Upheld on Employee Choice Doctrine: In *Lenel Systems Intl. Inc. v. Smith*, C.A. 11-02485 (N.Y. Appl. Div. May 3, 2013), a New York Court ruled that an employer could enforce a noncompete agreement with a former employee who voluntarily signed a stock option agreement that stipulated the options would be forfeited if he competed with or went to work for a competitor of the employer. Generally, New York (and many other state) laws discourage noncompete agreements, but where there is a clear choice for employees as to whether to take a specific benefit or go to work for a competitor, the court ruled the employer could enforce the noncompete.

New SAFE Rules in China: On April 25, 2013, the PRC State Administration of Foreign Exchange (SAFE) issued a new regulation, the "Notice on Implementing Information System for Capital Account Items" (Circular 17). The rule applies to all capital account items, including equity plan registrations under Circular 7, effective from May 13, 2013. Companies that have previously registered their equity plans with SAFE under Circular 7 now need to obtain a new monitoring code and business registration certificate. The process appears to be fairly simple, and local SAFE offices have been issuing the codes quickly.

Recommended Reading

Is Venture Capital Worth It? In a very good article on the *Forbes* Web site July 29, Dileep Rao writes that getting venture capital investing may not be worth it. Approximately 1,000 to 1,200 startups annually get venture capital for the first time. Of these, about two percent will actually be "home runs" (a return of 50–100 times over five years), while 20% to 30% will yield modest investment returns given the risk involved (about 20% per year over five years). But in return for the investment, entrepreneurs must give up substantial control and often much or most of the ultimate gain. If your company is one of the modest successes, you may find what you have built moving in a direction you don't want.

Angel Investor Raises Reason to Be Wary of Using JOBS Act : In an online post, Dan Rosen, an angel capital investor, lists several important precautions about using the JOBS Act for general solicitations. He says the new rules may actually make it more complex and risky to raise capital.

Senate Committee Looks at Changes in Equity Compensation Taxes: On his blog at myStockOptions.com, Bruce Brumberg looks at some of the issues in a May Senate Finance Committee document listing some potential areas of equity compensation that might be considered in any possible tax reform bill. They include changes to Section 409A, limiting deductions for equity pay to what the company charges as a compensation cost in the year the grant is made, and changing rules to Section 162(m) on excessive executive pay to limit the use of equity pay, among others.

The proposals are not staff recommendations, but a compendium of possible approaches the committee might consider, and are among hundreds of other tax ideas.

Founders Stock in Startups

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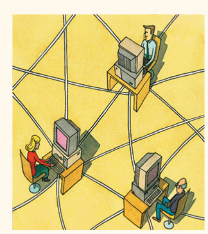
A vesting schedule protects the company and the other shareholders. It controls further dilution of existing shareholders if someone is hired to replace an exiting founder and issued stock. It also prevents an inactive shareholder who did not contribute to a company's success from benefiting from a future sale. Finally, venture capitalist funds will implement a vesting schedule on their own terms if there is not one in place already.

Margaret Steere is an attorney in Redwood City who advises companies on a variety of corporate issues, including all forms of employee ownership.

NCEO Equity Compensation Webinars



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AICPA Issues New Report on Guidelines for Valuation of Equity in Privately Held Companies

On May 29, 2013, the AICPA's Financial Reporting Executive Committee (FinREC) issued the Accounting and Valuation Guide Valuation of Privately-Held-Company Equity Securities Issued as Compensation. The new document replaces the 2004 edition.

The guide provides a detailed roadmap to valuation. It discourages the use of formulas to arrive at determination of value. Instead, valuation should proceed based on three standard approaches:

- The income approach uses measures such as earnings before interest, taxes, depreciation, and amortization to create either a projection of discounted future estimated earnings or a capitalization of existing earnings (the first is used when past earnings may not be a good predictor of future earnings). The core idea here is to assess value based on what a buyer might be willing to pay, given the risks of the investment and alternative uses for the money, to gain access to future free cash flow.
- The asset approach looks at book value and related measures.
- The market approach looks at sales of comparable equity interests in other companies. Transactions in secondary markets and private placements of equity should be considered in this approach, as well as outright company sales.

These three methods are weighted depending on the assessment of the appraiser to create a blended value. Valuation results need to be adjusted based on whether the shares have control rights or not (often not done in entrepreneurial companies) and liquidity issues.

A major difficulty in closely held companies is that many are not currently profitable or may not even have developed a significant income stream. Their future free cash flow is thus hard to predict. That means more emphasis would be placed on the market approach than, for instance, in the valuation of a mature private company with an ESOP. Nonetheless, the income approach should still be a important element of the process. One guide for that can be found in Appendix B of the Guide, which provides venture capital rates of return from a variety of sources.

Another key issue is what discount to apply to future projected cash flow. A common approach is the capital pricing model.