

## IRS Notice 2006-4: Any real relief from 409A for private company stock valuations?

On December 23, 2005, the IRS issued Notice 2006-4 in an apparent attempt to assuage concerns of private companies regarding their compliance with the recent option pricing guidance under Section 409A of the Internal Revenue Code.<sup>1</sup> The Notice may be found at [www.irs.gov/pub/irs-drop/n-06-04.pdf](http://www.irs.gov/pub/irs-drop/n-06-04.pdf).

Notice 2006-4 generally provides that:

- ▶ For stock options and stock appreciation rights (either, a “stock right”) granted before January 1, 2005, taxpayers may consider such rights to satisfy the Section 409A fair market value pricing requirement if there was a “good-faith attempt” to set the exercise price at not less than the stock’s fair market value on the date of grant; and
- ▶ For stock rights granted on or after January 1, 2005 and until Final Treasury Regulations under Section 409A become effective (anticipated to be January 1, 2007), taxpayers may use any reasonable valuation method or may use the guidance provided in the Proposed Treasury Regulations under Section 409A of the Internal Revenue Code (the “Proposed 409A Regulations”) to determine whether the exercise price of the right is at or above fair market value on the grant date.

**Lack of Clear Guidance.** It is possible that the IRS is sending a signal that it will find discounted exercise prices only in two situations: (i) the company intended to set the exercise price at less than the stock’s

fair market value on the date of grant; or (ii) the company used a clearly abusive procedure to determine the stock’s fair market value. Accordingly, some taxpayers may interpret Notice 2006-4 as providing comfort that their grants prior to 2005 will not be challenged as long as the company did not intend to grant an in-the-money right and otherwise was not acting in bad faith in establishing the value of its stock. Unfortunately, a close reading of Notice 2006-4 and related guidance does not yield such a conclusion. Naturally, the IRS’ true intent and the ultimate effect of the Notice will not be known for some time. However, due to the absence of clear guidance in the Notice, as outlined more fully below, we recommend caution in the reliance placed on Notice 2006-4.

**Background.** As explained more fully in our earlier *Cooley Alerts!* addressing the application of Section 409A to stock rights, any stock right having an exercise price less than the fair market value of the underlying stock determined as of the grant date constitutes a deferred compensation arrangement that typically will result in adverse tax consequences for the grant recipient and tax withholding responsibility for the granting company.

In December 2004, the IRS issued Notice 2005-1 which, among other things, confirmed that incentive stock options (“ISOs”) were exempt from Section 409A<sup>2</sup> and that, with respect to nonstatutory stock options, for purposes of determining the fair market value of the stock at the date of grant, any

reasonable valuation method may be used. On September 29, 2005, the IRS issued the Proposed 409A Regulations which approved certain methods for determining the fair market value of a company’s stock for purposes of granting stock rights that would avoid the application of Section 409A. A discussion of these methods may be found in our prior *Cooley Alerts!*:

- ▶ Private company stock option pricing in the 409A era: [www.cooley.com/news/alerts.aspx?ID=000039093920](http://www.cooley.com/news/alerts.aspx?ID=000039093920)
- ▶ Pricing public company stock options and SARs in the 409A era: [www.cooley.com/news/alerts.aspx?ID=000039093120](http://www.cooley.com/news/alerts.aspx?ID=000039093120)

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**Notice 2006-4.** On December 23, 2005, the IRS issued further guidance in the form of Notice 2006-4, which distinguishes between pre-2005 and post-2004 stock rights:

**Pre-2005 Stock Rights.** Stock rights granted before January 1, 2005 will be excluded from the application of Section 409A provided that there was a *good-faith attempt* to set the exercise price at not less than the stock's fair market value on the date of grant. Notice 2006-4 does not define or describe what constitutes a *good-faith attempt* to set the exercise price of a stock right. However, the Notice does state that until further guidance is issued, principles similar to those set forth in the Final Treasury Regulations governing ISOs (the "Final ISO Regulations") will be applied.

The Final ISO Regulations offer no real practical guidance, but state that whether there was a *good-faith attempt* depends on the relevant facts and circumstances,<sup>3</sup> and provide only a single example of a *good-faith attempt*. Specifically, the Final ISO Regulations provide that, if it is demonstrated that the fair market value of the stock on the date of grant was based on an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a determination generally establishes that a good-faith attempt to meet the ISO exercise price requirements was made. The IRS has declined to be any more specific through additional examples, noting only that many fair market value determinations (including those by the granting company) may not reliably reflect the fair market value of the stock on the date of grant.

Moreover, the Preamble to the Final ISO Regulations reminds taxpayers that they are required to retain adequate books and records to demonstrate that the option price requirements are satisfied. Thus, the Final ISO Regulations and its Preamble could be interpreted to require a *more rigorous* methodology and a more limited range of choices than what are available under the Proposed 409A Regulations.<sup>4</sup>

**Post-2004 Stock Rights.** For stock rights granted on or after January 1, 2005 and until the Final Treasury Regulations under Section 409A become effective, taxpayers may use *any* reasonable valuation method or may use the guidance provided in the Proposed 409A Regulations.

### What to do now

**Previously granted stock rights.** With respect to previously granted stock rights, we continue to recommend that companies review the exercise prices (and exercise price determinations) of such grants in light of the guidance contained in the Proposed 409A Regulations to confirm that such grants were made with an exercise price of not less than fair market value on the date of grant. Companies that have hired, or are contemplating hiring, an independent appraiser to determine whether grants made on earlier dates have an exercise price that was at or above fair market value generally should proceed to do so. Similarly, companies that intend to apply the valuation method prescribed by the Proposed 409A Regulations to earlier grants generally should proceed to do so. If such review indicates that all of the prior grants had an exercise price that was not less than the stock's fair market value on the date of grant, then the stock rights should satisfy the exercise price requirement for exemption from Section 409A regardless of when the right was granted.

If it is now determined that an exercise price of a stock right had been set below fair market value, companies also should review the process by which the exercise price was established to determine if the pricing process met the reasonable method/good faith standard applicable at the time the right was granted, thereby satisfying the Section 409A fair market value pricing requirement pursuant to Notice 2006-4. Because the reasonable method/good faith standard is so unclear, companies should exercise caution in relying on Notice 2006-4 in such circumstances.

If it appears that the exercise price of a stock right was less than the stock's fair

market value on the date of grant, and the company is not certain that the reasonable method/good faith standard was satisfied, then the company may employ one of the methods previously discussed to cure the discounted stock right of its Section 409A taint. See our prior *Cooley Alerts!* regarding how to address discounted stock rights:

- ▶ Private company stock option pricing in the 409A era: [www.cooley.com/news/alerts.aspx?ID=000039093920](http://www.cooley.com/news/alerts.aspx?ID=000039093920)
- ▶ Pricing public company stock options and SARs in the 409A era: [www.cooley.com/news/alerts.aspx?ID=000039093120](http://www.cooley.com/news/alerts.aspx?ID=000039093120)
- ▶ 409A: What you do (and don't) need to consider before year-end: [www.cooley.com/news/alerts.aspx?ID=000039345720](http://www.cooley.com/news/alerts.aspx?ID=000039345720)

**Future stock rights.** With respect to future grants of stock rights, we continue to recommend that companies follow the guidance in our prior *Cooley Alerts!* and price such stock rights in compliance with the guidance set forth in the Proposed 409A Regulations.

For more information, please contact one of the attorneys listed at the beginning of this *Alert* with whom you regularly consult. ■

### Notes

<sup>1</sup> Notice 2006-4 will be of primary interest to companies whose stock was not publicly traded when the stock right was granted. In limited circumstances, however, Notice 2006-4 may have implications for companies whose stock was publicly traded when the stock right was granted.

<sup>2</sup> Please note that, in order for an ISO to be exempt from the application of Section 409A, such option must have an exercise price that is not less than the fair market value of the underlying stock on the date of grant. Accordingly, ISOs present substantially the same valuation challenges under Section 409A as nonstatutory stock options ("NSOs") and stock appreciation rights ("SARs").

<sup>3</sup> The Final ISO Regulations are unclear as to whether a good faith attempt may be demonstrated only if the exercise price was determined in a reasonable manner (such as through one of the valuation methods that may be found in the gift and estate tax regulations).

<sup>4</sup> In our view, the standards set forth in the Final ISO Regulations were more rigorous than were generally thought to apply prior to their publication in August, 2004; in any event, it may be argued that the reasonable method/good faith standard prior to the publication by the IRS of the Proposed Treasury Regulations governing ISOs on June 9, 2003 was more liberal.