



COMPANY ADVISES EMPLOYEES ON EXERCISING STOCK OPTIONS BETWEEN VALUATIONS & AVOIDS TAX PENALTY



Challenge

Anticipating an increase in stock price, several employees who held stock options expressed a desire to exercise those options using the last 409A valuation. This could set off a cascade of tax consequences.



Solution

We advised the company to inform the employees that the spread value would be based on the upcoming 409A valuation, not the old valuation. We also advised the company to consider adding a blackout provision for all new stock option grants.



Result

The company informed its employees that they could exercise their options, but based on the forthcoming valuation, and they should keep the resulting tax implications in mind. The company also increased the frequency of their 409A valuation and implemented a blackout period.

A privately held company was approaching a new financing round. Anticipating an increase in stock price, several employees who held stock options expressed a desire to exercise those options using the last 409A valuation. Due to the upcoming financing round, the company's outside valuation firm had indicated a material change in value to the business, which meant that the old 409A valuation was no longer valid.

THE TAX ISSUE

If the company used this old price to determine the spread on exercise, they ran the risk of underreporting income from the exercise of the options to the IRS. This could set off a cascade of tax consequences, including failure to report compensation, failure to withhold income and employment tax, and a loss of the deduction on compensation charges. In such situations, the company, not the employee, is liable for the underreported taxes and penalties. Any mistakes could quickly become exceedingly expensive.

OUR SOLUTION

The company had engaged Armanino's CFO Advisory team to handle their equity compensation administration and reached out to the firm for assistance with their option exercise concerns. Because valuations can be expensive, they wanted to know if the valuation they had done previously was valid for determining the spread value of the exercised options until their new 409A valuation was finished.

Armanino informed them that using the old valuation to determine spread value had inherent risks for the reasons mentioned above. Most stock option plans allow employees to

exercise any time after vesting, without blackout provision — which prohibits optionees from exercising their options between valuation reports — the company was legally obligated to allow its employees to exercise their options at any time.

We advised the company to inform the employees that the spread value would be based on the upcoming 409A valuation, not the old valuation. As the spread is taxed as compensation instead of capital gains, the employees had to decide whether to exercise before they knew the fair market value from the forthcoming valuation. We also advised the company to consider adding a blackout provision for all new stock option grants.

THE RESULT

Heeding our advice, the company informed its employees that they could indeed exercise their options, but that the exercise would be based on the forthcoming valuation, and they should keep the resulting tax implications in mind. Ultimately, the company chose to increase the frequency of their 409A valuations from annually to quarterly and implement a blackout period, with an exception for terminated employees where options would expire during the blackout period. Going forward, optionees who qualify for exceptions will have a spread based on the new 409A valuation if they choose to exercise. Outside of those exceptions, optionees must wait until the new valuation is in hand.



OUR EXPERT

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