What to Do If Your Employees Want to Exercise Stock Options Between 409A Valuations

CASE STUDY

armanino

At A Glance

Challenge:
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valuation firm had indicated a material change in value to the business, which meant that the old 409A valuation was no longer valid.

Solution:
Inform the employees that the spread value would be based on the upcoming 409A valuation, not the old valuation.

Result:
Chose to increase the frequency of their 409A valuations from annually to quarterly and implement a blackout period, with an exception granted for terminated employees and options that would expire during the blackout period.

Client Challenge

A privately held company was approaching a new financing round. Anticipating an increase in stock price, a number of employees who held stock options expressed a desire to exercise those options using the last 409A valuation.

Most companies will use a 409A valuation to determine both the exercise (or strike) price and the option spread — the difference between the fair market value of the underlying stock on the exercise date and the strike price. A 409A valuation performed by an independent appraiser generally provides a safe harbor where the burden of proof is on the IRS to show that the strike price of an option wasn't set to fair market value.

Under the 409A rules, the valuation can be used for up to one year, but that one-year period truncates "if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation." However, when an option is exercised, determining the fair market value of the stock on the exercise date falls under Section 83 of the Internal Revenue Code, which states that fair market value must be determined as of the date of exercise, when the stock is transferred to the optionee.

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valuation firm had indicated a material change in value to the business, which meant that the old 409A valuation was no longer valid. 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.

Armanino's 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 Tax partner Peter Klinger 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 at any time after vesting, and without a 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.

Klinger advised that the company 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. In addition, he advised the company to consider adding a blackout provision for all new stock option grants.

The Result

Heeding Klinger's 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 those aforementioned 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.

About Armanino

Armanino provides an integrated set of accounting services—audit, tax, consulting and technology solutions—to a wide range of organizations operating both in the US and globally. You can count on Armanino to think strategically, to provide the sound insights that lead to positive action. We address not just your compliance issues, but your underlying business challenges, as well—assessing opportunities, weighing risks, and exploring the practical implications of both your short- and long-term decisions. When you work with us, we give you options that are fully aligned with your business strategy. If you need to do more with less, we will implement the technology to automate your business processes. If it's financial, we can show you proven benchmarks and best practices that can add value company-wide. If the issue is operational, we'll consult with your people about workflow efficiencies. If it's compliance, we'll ensure you meet the requirements and proactively plan to take full advantage of the changes at hand. At every stage in your company's lifecycle, we'll help you find the right balance of people, processes, and technology.

Our Expert

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