



FENWICK & WEST LLP

Executive Compensation and Benefits

Notice 2006-4: Interim Guidance on Private Company Stock Valuation

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On December 23, 2005, the IRS issued interim guidance in the form of Notice 2006-4 regarding stock valuation for privately-held companies pending the finalization of the proposed regulations under Section 409A of the Internal Revenue Code of 1986, as amended (the Code). It is expected the proposed regulations will be finalized in the second half of 2006 and will become effective January 1, 2007.

Background

409A applies to nonstatutory stock options and stock appreciation rights, granted at less than fair market value on the date of grant that were unvested after December 31, 2004. It also applies to vested stock options that are materially modified after October 3, 2004. If such a stock option or stock appreciation right is granted at less than fair market value on the date of grant (or is materially modified at the time when the exercise price is less than the current fair market value), 409A imposes severe tax consequences upon the employee/service provider which requires income recognition at ordinary income rates plus a 20% penalty tax on the amount of ordinary income recognized.

The Clear Take-away of Notice 2006-4 for Options Granted Prior to January 1, 2005 (the “Good Faith” standard applies)

In light of 409A and the issuance of both Notice 2005-1 (on December 20, 2004) and the proposed regulations (on October 4, 2005), the determination of fair market value has been at the forefront of concern for privately-held and venture-backed companies, with specific concern that the valuation methods in Notice 2005-1 or the proposed regulations would apply “retroactively” to unvested options and stock appreciation rights outstanding as of December 31, 2004.

The good news of Notice 2006-4 is that there will no “retroactive” reach of the valuation methods set forth in either Notice 2005-1 or in the proposed regulations with respect to options outstanding as of December 31, 2004 and not modified thereafter. Instead, for options granted (whether or not vested) prior to January 1, 2005,

the method for determining fair market is the same “good faith” standard that currently applies to incentive stock options (ISOs). That method requires only that the determination of fair market value must be made in “good faith” by a company’s board of directors. Any determination is based on all the relevant facts and circumstances on the date of grant.

Options and Stock Appreciation Rights Granted on or After January 1, 2005 (Reliance on either Notice 2005-1 or the Proposed Regulations Permitted)

Notice 2006-4 also clarifies that a privately-held company may rely on either the method set forth in Notice 2005-1 or on the methods contained in the proposed regulations until the final regulations are issued.

Under Notice 2005-1, fair market value on the date of grant of a nonstatutory stock option can be determined using “any reasonable valuation method.” Notice 2005-1 includes only one example of a reasonable valuation method, that provided by the Estate Tax Regulations. Accordingly, Notice 2005-1 did not provide much guidance for determining fair market value of nonstatutory stock options and stock appreciation rights.

In response to concerns raised by privately-held companies that further guidance was needed for providing methods to determine fair market value, the proposed regulations provided that fair market value could be determined by the “reasonable application of a reasonable valuation method.” The proposed regulations set forth certain factors to consider when determining a reasonable valuation method. More usefully, the proposed regulations provided three “safe harbors,” two of which are particularly relevant for privately-held companies. These are (1) valuation by an independent third party appraiser and (2) valuation using a written report of an internal expert where the company is an illiquid start-up corporation. If one of the safe harbors is consistently used, it provides a presumption that the fair market value of the stock underlying the option is reasonable and places on the IRS the burden to demonstrate that the determination of fair market value or its application was “grossly unreasonable.”

We believe that Notice 2006-4 does not significantly alter the approach a privately-held company should use when determining the fair market of its stock on a going forward basis. We believe that the safe harbors contained in the proposed regulations should be used on a going forward basis because the safe harbors provide a presumption of reasonableness that places on the IRS the burden to demonstrate that the valuation used was grossly unreasonable. If for some reason the safe harbors are not available, the automatic fallback is to the reasonable valuation method rules contained in both Notice 2005-1 and the proposed regulations, which we believe to be substantially similar.

One additional note — ISOs are exempt from 409A. Fair market value for an ISO is governed by the “good faith” standard both before and after January 1, 2005. However, we believe the IRS will at some point prior to 2007 clarify that fair market value, for both ISOs, as well as nonstatutory stock options and stock appreciation rights, will be governed by the standards ultimately contained in the final regulations under 409A. It is counterintuitive to imagine that two different standards will apply when determining fair market value of company stock.

Conclusion

Notice 2006-4 is significant because it clarifies that the “good faith” standard may be relied upon with respect to nonstatutory stock options and stock appreciation rights granted prior to January 1, 2005.

Notice 2006-4 does not, in our view, alter the approach a privately-held company should take in determining fair market of its stock on a going forward basis. We continue to believe that the most prudent course of action is to rely upon one of the safe harbors (either a valuation by an independent third party appraiser or the written report of an illiquid start-up corporation) set forth in the proposed regulations.

If you have any questions regarding this notice please call Scott Spector at (650) 335-7251 sspector@fenwick.com or Blake Martell at (650) 335-7606 bmartell@fenwick.com.

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