
Helpful New Section 409A Guidance Regarding Fair Market Value Determination for Stock Options and Stock Appreciation Rights

2005-12-27

Overview

On December 23, 2005, the Internal Revenue Service released Notice 2006-04 (the Notice), which clarifies the transition rules for determining whether stock options and stock appreciation rights (collectively, stock rights) are granted with a fair market value exercise price. The Notice adopts the standard for establishing fair market value for incentive stock options for stock rights that were granted before January 1, 2005. As a result, a good faith attempt to establish a fair market value exercise price for stock rights granted before January 1, 2005, is effective to exempt those rights from Section 409A (assuming the rights have no other deferral feature). Stock rights granted after January 1, 2005, must comply with the higher standards for determining fair market value set forth in previous guidance issued under Section 409A, as described below.

Background

Stock rights with an exercise price that is at least equal to the fair market value of the company's common stock on the date of grant (and that do not otherwise have a deferral feature) are exempt from Section 409A. As described in our [previous alert](#), the determination of fair market value under the proposed Section 409A Regulations requires a much more rigorous assessment of the facts and circumstances related to the value of the company's stock than many private companies have historically used, and Section 409A requires documentation of the valuation process. Because Section 409A applies to stock rights that are granted, or that vest after January 1, 2005, many companies were concerned that their valuation process would not be sufficient to exempt pre-2005 options from Section 409A even though the companies intended to grant options with fair market value exercise prices.

Effect on Stock Rights Granted Before January 1, 2005

Stock rights granted before January 1, 2005, will be exempt from Section 409A provided that the company used a good faith effort to set the exercise price at the fair market value of the company's stock on such date (and the right does not otherwise have a deferral feature), even if the company's

valuation process would not satisfy the valuation standards currently required under Section 409A. As such, a company that can satisfy this good faith standard should only need to consider the application of Section 409A to those pre-2005 stock rights that were intentionally issued at a discount or that include a deferral feature.

Effect on Stock Rights Granted After January 1, 2005

For stock rights granted after January 1, 2005, companies must satisfy the valuation standards required under Section 409A in order to exempt the rights from the new law. However, the recent Notice makes clear that for stock rights granted after January 1, 2005, and before January 1, 2007 (the proposed effective date for the Section 409A Regulations), companies can rely on the "any reasonable valuation method" standard set forth in Notice 2005-1 for determining fair market value. For stock rights granted after January 1, 2007, unless the final Regulations provide otherwise, companies must comply with the rigorous standard set forth in the proposed Regulations for determining fair market value, which requires a reasonable and consistent use of a reasonable valuation method that considers all relevant facts and circumstances. See our [previous alert](#) on this issue for a more thorough discussion of the valuation standard in the proposed Regulations.

Other Guidance

The Notice also states that the IRS may include more detailed valuation standards in the final Treasury Regulations in order to provide companies with more certainty that their valuation process will satisfy the Section 409A requirements. In addition, the IRS acknowledged taxpayer concerns about qualifying for the exemption from 409A for certain stock rights and the treatment of modifications, extensions and renewals of stock rights. To that end, the IRS requested additional comments from taxpayers regarding such issues, as well as proposals for additional transitional relief with respect to such issues.

For more information on Section 409A, please see our other [email alerts](#), or contact the authors listed above.

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