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Guest Commentary: Startups need to budget for 409A costs

By Matthew Henshon

With the first quarter rapidly drawing to a close, many businesses have completed their budgeting for 2006. But if you are a private enterprise, you had better leave room for a new line item: "409A Compliance."

Just as public companies have struggled with Sarbanes-Oxley compliance, private companies face the new Internal Revenue Code Section 409A, which takes a much more critical, and expensive, view of stock options.

Private companies fix a valuation when funds are raised; but valuations can swing wildly depending on the eye — and agenda — of the beholder of a term sheet. Liquidation preferences, voting agreements and director seats are also typically part of the negotiation of a funding deal, all of which make it more difficult to correctly value common stock, which is usually used in the option pool.

But it is clear that Congress, by passing 409A and empowering the IRS to enforce it, is turning a skeptical eye to the valuations used to calculate option grants. The proposed regulations state that companies must follow designated procedures for valuing stock options (called "safe harbors").

For tech companies, there would seem to be two relevant safe harbors: One, a valuation report made by a person (think: independent board member) who has "significant knowledge and experience" and is willing to accept the responsibility; or two, an "independent appraisal" made no more than a year before the relevant option grant. Realistically, most young companies will have to turn to the second option — and such third-party valuations seem likely to be expensive.

Failure to qualify for a safe harbor, followed by IRS disallowance of the ultimate valuation used, would subject option recipients to a penalty of 20 percent. Such a penalty will sting: an employee tagged with a 20 percent penalty might turn to a company's officers or directors who failed to ensure that the options were issued through a safe harbor.

And it seems reasonable to assume that D&O insurers will begin to disclaim such coverage.

The underlying law — Section 409A — is in effect right now; and although the rules are not in final form, they are likely to be finalized by the end of this year.

With these proposed regulations, Congress and the IRS are reviewing private company valuations closely. Companies will be under pressure to ensure that those valuations, when related to option grants, can be justified via a safe harbor.

But imposing strict regulations on private tech companies carries its own risks. And more to the point, 409A seems likely to impose costs on young companies that no one is budgeting for right now.

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