

## Protecting Yourself from the Pitfalls of 409A: An Appraiser's View

By Alex Hodgkin, ASA, AVA

Over the last few years, both public and privately-held companies have struggled with the complexity of incorporating equity participation into compensation plans for employees. Terms like *409A*, *Practice Aid*, *qualified appraiser*, and *safe harbor methods* are suddenly part of the everyday lexicon of most compensation professionals. At the same time, debate still rages and confusion abounds about just how companies achieve compliance in developing their compensation policies and practices.

Internal Revenue Code section 409A created a wave of discussion as companies scrambled to implement equity compensation policies that comply with the new regulation. Finalized in April 2007, 409A applies to discounted stock options and stock appreciation rights (SARs) defined as deferred compensation. Under 409A, stock options that have an exercise price less than the fair market value of the underlying stock as of the grant date could result in adverse tax consequences for the option recipient. The gain is subject to taxation at the time of option vesting rather than the date of exercise, with potentially devastating penalties and interest charges. In short, the consequences for noncompliance, which affect the individual who holds the options and not the issuing company, are significant.

Section 409A, while lengthy and complex, does outline some reasonably clear approaches on how to develop compliant policies. These presumptive methods, known as safe harbors, shift the burden of proof of noncompliance to the IRS if implemented properly. That simply means that if a company employs a safe harbor method to value the price of its stock options, the IRS must show that the company was grossly unreasonable in calculating the fair market value of the underlying security before wrongdoing may be claimed.

There are a number of these safe harbor methods, including: the *illiquid start-up*, *binding formula*, and *independent appraisal* approaches. In order for any of the safe harbors to comply, however, the method must incorporate evaluation of a number of factors, including: (i) the value of tangible and intangible assets of the company, (ii) the present value of future cash flows, (iii) the public trading price or private sale price of comparable companies, (iv) control premiums and discounts for lack of marketability, (v) whether the method is used for other purposes, and (v) whether all available information is taken into account in determining value.

Needless to say, many compensation professionals employ the services of a third-party firm to perform valuations for regulatory purposes such as 409A. The theory is that an independent appraisal offers the most effective protection. However, even this poses its own challenges, since identifying competent professionals and understanding the standards to which 409A valuations will be held remain difficult. Why? Simple: What constitutes a competent and capable valuation professional? Even though a number of professional organizations provide valuation training and credentials, there is no single universally accepted governing body. Moreover, the valuation community has not yet fully developed a robust body of knowledge concerning valuations performed for these purposes. Finally, as the regulations are quite new, no companies have yet had to defend their 409A valuation conclusions with the IRS.

Still, there is good news. Valuations for tax purposes are not new. As a result, there is a reasonable amount of information available on how to conduct a valuation suitable for presentation to the IRS, as well as how the IRS currently assesses the competency of valuation professionals. What is clear is that it's not sufficient to get the simple safe harbor compliance of an independent appraisal. Instead, to fully enjoy the additional protections offered by shifting the burden of proof, the wise compensation professional should procure a *qualified appraisal* from a *qualified appraiser* as those are defined in tax documents and recent court rulings.

Guidance on where to turn for meeting those requirements comes from a variety of sources, such as legislation and IRS position statements. For example, Section 1219 of the Pension Protection Act of 2006 provides that a qualified appraisal must include certain details and methodologies that someone adept in finance – but not necessarily practiced in the art of valuation – may not comprehend.<sup>1</sup> These details include specifics about the actual entity and its value, qualifications of the appraiser, and the valuation analysis itself. As to the specific

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<sup>1</sup>□m Pub. 561, "Determining the Value of Donated Property", Department of the Treasury, Internal Revenue Service (Rev. October 2005), p. 9

methodologies, there are in fact many to choose from. According to the IRS, the requirements specific to 409A were initially developed after a review of generally accepted valuation methodologies, as well as the Uniform Standards of Professional Appraisal Practice (USPAP), a valuation benchmark. The list of accepted valuation methodologies has expanded as innovative practitioners create new ways to examine vexing problems.

The quality of appraisal is critical, but it's only one part of the overall insurance package you are buying when you get an independent appraisal. Another piece of the puzzle is the qualifications of the appraiser him- or herself. Thankfully, additional legislation has tightened the definition of just what constitutes a qualified appraiser. The current set of standards encompassed by the definition include the following:

- An appraisal designation from a recognized professional appraiser organization;
- Regular performance of appraisals for which the individual receives compensation;
- Demonstration of education and experience in valuing the type of entity subject to the appraisal.<sup>2</sup>

Currently, there are essentially four recognized professional appraiser organizations, each offering its own valuation credential. These include: 1) American Society of Appraisers (ASA), offering an ASA or AM; 2) American Institute of Certified Public Accountants (AICPA), offering an ABV; 3) National Association of Certified Valuation Analysts (NACVA), offering an AVA, CVA; and 4) Institute of Business Appraisers (IBA), offering a CBA, BVAL, or AIBA. While there is some debate regarding which credential is best, all of these currently provide sufficient evidence of minimum education in the profession for purposes of satisfying the qualified appraiser requirement under current IRS regulations.

Recent court rulings shed additional light. In *Herbert V. Kohler, Jr. v. Commissioner of Internal Revenue*, United States Tax Court, T.C. Memo 2006-152, July 25, 2006, the court clarified the instances in which the burden of proof shifted to the IRS.<sup>3</sup> In *Kohler*, the court ruled that the burden of proof shifted to the IRS because the petitioner introduced credible evidence, substantiated material claims, maintained required records, and cooperated with the IRS. In deciding for the taxpayer, the court stated that it was impressed with the valuation methodologies utilized by the taxpayer's experts, as well as the fact that the expert was a certified appraiser.

In the end, we are struck by the importance of two key pieces relevant to 409A compliance: appraiser *and* appraisal. Clearly, not only is it important to use reputable, qualified appraisers, but it is also critical that such professionals follow generally accepted valuation standards to craft robust appraisal reports. Without both, you are not fully protected from the perils and pitfalls of noncompliance with 409A.

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<sup>2</sup> Pub. 561, "Determining the Value of Donated Property", Department of the Treasury, Internal Revenue Service (Rev. October 2005), p. 10

<sup>3</sup> Bravo, Stephen J., "The Burden of Proof", *Business Valuation Review*, Winter 2006, p. 136