



Valuing stock options? What will the IRS say?

How can auditors and corporate executives better understand fair market value determinations under IRC Sec. 409A in light of prior fair value for financial accounting reports or transactions? Valuation specialists suggest reviewing the prior fair value conclusions for the reasonableness of their standards and outcomes, especially in today's economic market, and then checking to see whether they are consistent with fair market value determinations, pursuant to current IRS standards. In addition, consider the following:

- *Subsequent events.* The IRS currently supports considering subsequent events if they are reasonably “known or knowable” at the valuation date and are relevant to the valuation. See, e.g., *Estate of Noble* (Tax Ct. Memo 2005).
- *Appraisal penalties.* The IRS has explicitly stated that appraisal penalties will apply to valuation reports that are either *over* or *undervalued*. (Penalties for *undervalued* valuations were not previously clear.) Further, the IRS is working on establishing clear standards for what constitutes a “qualified” appraisal/ appraiser.
- *Enforcement.* IRS enforcement procedures are still in preliminary stages; the Service is simply trying to review as many valuation reports as possible and is selecting those that appear, on the surface, to be unreasonable or to lack credibility. In the context of 409A, those that lack independent valuation analysis may raise red flags; and even valuation specialists should demonstrate a thorough understanding of the subject company.
- *Internal valuations.* In the context of 409A, the Service generally questions whether company-generated valuations even qualify as appraisals. One page of management analysis is certainly not sufficient and requires adequate support and substantiation, just like any qualified appraisal.
- *Pre-audit conversations.* Another benefit of an independent valuator: The IRS may seek additional information from the preparer of the 409A valuation before beginning a full-scale audit, which will still take place at the taxpayer level.
- *Cost or current value approach.* The IRS does not categorically reject any methodology, but instead applies the general standards of reasonableness, relevance, and credibility. Above all, a report must clearly identify the valuation assumptions and the methods by which they were derived. In general, however, the cost approach is not relevant to 409A valuations.
- *Income and market approaches.* The income approach should evaluate the path to profitability; the market approach typically incorporates a “back-solve.” Note: Given current market conditions, analysts should check their traditional reliance on prior transactions, and poll investors for their perspectives on the latest financing round.
- *Stock option pricing models* should capture: i) the effect of the economy and its influence on early stage companies and option grants; ii) a slow IPO market; iii) increased venture funding in a depressed economy; iv) advanced and outstanding options; v) companies that have yet to produce any products; vi) management incentives, such as executive shares; vii) “down rounds” and mandatory subsequent rounds of financing, originally contemplated as part of a venture capital investment plan; and viii) subsequent rounds of “arm’s length” financing if all of the same investors participate.

Ultimately, 409A valuations rely on a thorough, fact-intensive inquiry of early-stage valuations, supported by good judgment and analysis. Circumstances will particularly drive complex matters: So much depends on factors such as the strength of the company, the strength of its investors, the nature of the industry, and the cycle in the economy.