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When 409A Meets Gift Tax: Aligning Valuations Without Crossing the Line

EXECUTIVE SUMMARY

As equity-based compensation and estate planning continue to converge, valuation professionals, attorneys, and CPAs are increasingly navigating the intersection of IRC §409A valuations and gift tax valuations. While both seek to determine the value of private company stock, they differ sharply in purpose, standards, and methodology. Confusing the two—or worse, repurposing a 409A valuation for gift tax reporting—can lead to compliance failures, IRS challenges, and wasted exemptions. Yet, with careful coordination, the two regimes can be harmonized to strengthen both planning and defensibility. This newsletter explains the key differences, highlights common traps, and offers practical steps to bridge 409A and gift tax valuations effectively.

COMMENT

The Two Regimes: Same Company, Different Purposes

Section 409A governs the timing of income recognition for nonqualified deferred compensation. It ensures that stock options and similar awards are granted at or above fair market value (FMV) to prevent premature taxation. Under Treas. Reg. §1.409A-1(b)(5), a valuation is considered 'reasonable' if based on recognized methods and appropriate facts. Three safe harbors establish a rebuttable presumption of reasonableness: Independent Appraisal, Consistent Formula Valuation, and Illiquid Startup Safe Harbor.

Gift tax valuations, by contrast, determine FMV for transfer tax purposes under Treas. Reg. §25.2512-1. Gift valuations must reflect FMV as of the exact date of the gift and apply appropriate discounts such as DLOC and DLOM. Unlike 409A valuations, there are no statutory safe harbors; instead, FMV relies on facts and circumstances guided by Rev. Rul. 59-60 and professional standards.

Why Confusion Happens

Because both valuations often involve the same company, the same financial statements, and similar analytical tools, it is easy for advisors or clients to assume they can serve dual purposes. However, the context and perspective differ dramatically—409A reflects an internal compensation view, while gift tax valuation represents an external, arms-length FMV transaction perspective.

Where the Lines Blur

A 409A valuation is often misused for gift tax filings. For instance, a \$10 per share 409A value may omit discounts that reduce FMV to \$5.60. Overstating wastes exemption; understating risks IRS penalties. Timing differences also matter: a 409A may remain valid for 12 months absent material change, while gift valuations must reflect the exact date of transfer.

Adequate Disclosure: A Critical Oversight

Under Treas. Reg. §301.6501(c)-1(f)(2), the statute of limitations for IRS examination of a gift tax return begins only when the gift is adequately disclosed. A 409A report rarely meets this standard. Without a compliant appraisal, the IRS may challenge the valuation indefinitely.

IRS Scrutiny and Enforcement Trends

IRS memoranda, such as CCA 202152018 and CCA 201939002, emphasize that 409A valuations cannot substitute for gift tax FMV analyses. Each valuation serves distinct legal objectives and must be prepared accordingly.

Opportunities for Coordinated Planning

When handled correctly, coordinated planning between compensation and estate advisors can create strategic alignment. Timing valuations, sharing assumptions, and documenting rationale can strengthen defensibility. Use the 409A valuation for factual inputs but not as the final FMV conclusion.

Pitfalls and Red Flags

- Using outdated valuations or ignoring material events
- Failure to apply DLOC/DLOM in minority interests
- Relying solely on 409A safe harbors for FMV
- Inadequate disclosure that leaves the statute of limitations open
- Inconsistent assumptions between 409A and gift valuations

Best Practices for Advisors

- Collaborate early between estate planners, compensation counsel, and valuation experts.
- Use independent appraisers with experience in both 409A and gift tax.
- Tailor each valuation to its legal purpose.
- Monitor IRS guidance and case law.
- Document all assumptions and rationale.

Conclusion

As the boundaries between executive compensation and estate planning continue to blur, the temptation to reuse 409A valuations for gift tax purposes will only grow. Yet, the two regimes remain governed by different standards. Handled carelessly, this overlap can lead to compliance exposure; handled correctly, it offers defensible, strategic planning opportunities.

Key Takeaways for Advisors

- Never rely on a 409A valuation 'as-is' for a gift tax return.
- Apply DLOC and DLOM where appropriate.
- Coordinate valuation dates and assumptions.
- Ensure adequate disclosure compliance.
- Engage appraisers fluent in both valuation regimes.

About the Authors

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