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Bridging Section 409A And Gift Tax Valuations

Opportunities and pitfalls

As estate planning and executive compensation strategies become increasingly sophisticated, the intersection of Internal Revenue Code Section 409A valuations and gift tax valuations has emerged as a critical area of focus for attorneys, CPAs and valuation professionals.

While both valuation regimes aim to determine the value of private company stock, they serve distinct legal purposes and are governed by different standards. It's important to state that an IRC Section 409A valuation isn't considered a fair market value (FMV) standard under IRC Section 2512. Rather, it's a compliance-driven valuation designed specifically for regulating deferred compensation. Yet, in practice, these valuations often overlap creating both opportunities and risks.

This convergence is particularly relevant in today's environment of Internal Revenue Service scrutiny, increased use of equity-based compensation and aggressive estate-planning strategies. Practitioners must be vigilant in understanding when a Section 409A valuation can support a gift tax position and when it can't. Missteps can lead to IRS adjustments to reported gift values, penalties and interest. In rare cases, the IRS may challenge specific planning structures.

Let's explore the key differences between Section 409A and gift tax valuations, identify areas where the lines blur and provide practical guidance for leveraging synergies while avoiding common pitfalls.



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Two Regimes

It's important to understand the two regimes involved: (1) Section 409A valuations, and (2) gift tax valuations.

Section 409A valuations: purpose and standards. Section 409A governs the taxation of nonqualified deferred compensation. Deferred compensation plans enable key employees to defer a portion of their salary or bonuses for payment later, often after retirement, allowing them to delay income taxes until they receive the money, potentially in a lower tax bracket. To avoid immediate income inclusion and penalties, companies must ensure that stock options and other equity awards are granted at or above FMV.

For private companies, while an independent appraisal isn't legally required, relying on a Section 409A safe harbor (most commonly an independent appraisal) provides a rebuttable presumption that the strike price reflects FMV.

Under Treasury regulations, companies may rely on three safe harbors to establish that a stock valuation is "reasonable" for Section 409A purposes. The most common is the independent appraisal presumption, which requires a valuation by a qualified independent appraiser within the past 12 months and creates a presumption of reasonableness if properly performed. A second option is the consistent formula valuation, which uses a formula method (such as book value or an earnings multiple) tied to a non-lapse restriction under IRC Section 83, provided it's applied consistently across all insider and related-party transactions, though it's rarely used due to its inflexibility. The third option is the illiquid startup valuation, available to startups under 10 years old with no public securities and no imminent initial public offering or change of control. This valuation requires a good faith written report that considers



all relevant factors prepared by a qualified individual with at least five years of valuation, finance or industry experience.

It's also important to recognize that while reliance on a Section 409A safe harbor, such as an independent appraisal, provides a presumption of reasonableness and creates a rebuttable presumption of reasonableness (which the IRS may overcome with contrary facts), it doesn't render the valuation immune from scrutiny or challenge. The IRS may still examine the underlying assumptions, methodologies and factual circumstances and can disregard a valuation if it determines that it wasn't reasonable or properly performed in light of all relevant facts. Thus, safe harbor protections are significant but not absolute, and practitioners should avoid a false sense of security when leveraging them in planning or audit defense.

Gift tax valuations: FMV and discounts.

In contrast, gift tax valuations are governed by the FMV standard under Treasury Regulations Section 25.2512-1. FMV is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Gift tax valuations may involve applying discounts for lack of control (DLOC) and lack of marketability (DLOM) when valuing interests that are minority, non-controlling or illiquid in closely held businesses. These discounts can materially reduce the taxable value of a gift, serving as a strategic estate-planning tool, but may potentially attract IRS scrutiny. By contrast, controlling or marketable interests typically don't warrant such discounts, as their nature allows for greater influence over company decisions or easier conversion to cash.¹

Where the Lines Blur

Clients may be inclined to use a Section 409A valuation for gift tax purposes. After all, both valuations aim to determine the value of the same asset—private company stock—often at the same point in time. However, the legal standards, assumptions and intended uses differ significantly.

Misuse of Section 409A valuations in gift tax contexts. A common pitfall is using a Section 409A

valuation “as-is” to support a gift tax return. While a 409A valuation may be rigorous, it's designed to support deferred compensation compliance, not to withstand IRS scrutiny in a gift tax audit. For example, Section 409A valuations may exclude discounts such as DLOC or DLOM or may rely on allocation methods that don't translate directly to FMV under gift tax rules.

Timing and methodology differences. Timing can also create discrepancies. A Section 409A valuation is typically valid for up to 12 months absent a material event, although many companies update their valuations more frequently. Meanwhile, a gift tax valuation must reflect the FMV on the exact date of the gift. Additionally, Section 409A valuations often rely on option pricing models (for example, Black-Scholes or Probability-Weighted Expected Return Method), which may not align with the income or market approaches favored in gift tax contexts.

Example: Divergent Outcomes

Consider a founder who receives a Section 409A valuation of \$10 per share for common stock in a startup. The same founder gifts shares to a family trust and uses the \$10 value on a gift tax return. However, a proper gift tax valuation might apply a 30% DLOM and a 20%² DLOC, reducing the FMV to \$5.60 per share. If audited, the IRS could dispute the appropriateness of using the unadjusted Section 409A value for gift tax purposes and assert that the valuation didn't reflect FMV on the date of the gift. See “Comparison of Valuations” p. 46.

Strategic Planning

Despite the risks, there are legitimate ways to align Section 409A and gift tax valuations to support strategic planning, if done carefully.

Coordinating valuation dates and assumptions.

When planning a gift and a stock option grant simultaneously, advisors can coordinate valuation efforts to ensure consistency in assumptions, financial projections and market data. While the valuation methods may differ, aligning the underlying inputs can enhance the defensibility of the valuation.

Using 409A as a starting point. If used at all, the



COMMITTEE REPORT: VALUATIONS

Section 409A report should inform factual inputs (financials, cap table, preferences, rights and recent events) and not serve as a numerical base for adding gift tax discounts without reconciling level-of-value and date-of-valuation differences.

Leveraging consistency to reduce audit risk. Consistency across valuations can reduce audit risk. If the IRS sees wildly different values for the same stock within a short period, it may raise red flags. By documenting the rationale for any differences, such as changes in control, liquidity or market conditions, advisors can preemptively address potential challenges.

Pitfalls and Red Flags

Here are some pitfalls and red flags to watch out for:

Using Section 409A “as-is.” Perhaps the most significant pitfall is using a Section 409A valuation without modification for gift tax purposes. This approach ignores the different legal standards and can lead to overvaluation or undervaluation, depending on the facts.

Ignoring discounts and control issues. Gift tax valuations must consider whether the gifted interest is a minority or non-controlling stake and whether it lacks marketability. Failing to apply appropriate

Comparison of Valuations

The differences can result in divergent outcomes

Aspect	Internal Revenue Code §409A Valuation	Gift Tax Valuation
Purpose	Compliance with IRC §409A to set strike price for stock options and avoid immediate income inclusion/penalties.	Determine fair market value (FMV) of transferred property for estate and gift tax reporting.
Governing standard	Reasonable valuation method under Treasury Regulations §1.409A-1(b)(5).	FMV under Treas. Regs. §25.2512-1 (“willing buyer, willing seller” test).
Safe harbors	(1) Independent appraisal within last 12 months; (2) consistent formula valuation; and (3) illiquid start-up valuation (under 10 years old, no initial public offering/control event expected).	No safe harbors; IRS and courts rely on facts-and-circumstances analysis of FMV.
Interest valued	Typically common stock or service recipient stock for option pricing purposes (minority perspective).	Specific interest transferred (control vs. minority, voting vs. non-voting, etc.).
Discounts/premiums	Often excludes discount for lack of control (DLOC) / discount for lack of marketability (DLOM); may use option-pricing allocation methods that impute minority value.	Explicit application of DLOC, DLOM, blockage discounts or control premiums depending on facts.
Timing	Valuation is valid for 12 months absent a material change.	Must reflect FMV as of the exact date of the gift.
Methodologies	May rely on option pricing method (OPM) (Black-Scholes, Probability-Weighted Expected Return Method) to allocate enterprise value across classes.	Income, market and asset approaches common; less reliance on OPM unless appropriate.
Internal Revenue Service scrutiny	Focused on whether options were granted at or above FMV to avoid §409A penalties.	Focused on whether reported gift values understate FMV to minimize transfer taxes.
Consequences of misvaluation	Potential immediate income inclusion, 20% penalty, interest charges on deferred compensation.	Potential gift tax deficiency, penalties and interest; possible challenge to estate-planning transactions.

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DLOC and DLOM can result in inflated values and increased tax liability.

Lack of documentation. It's necessary to document the rationale for using a particular valuation method or set of assumptions. In the event of an audit, quality documentation can be the difference between a successful defense and a costly adjustment. See "A Tale of Two Valuations," this page.

Best Practices for Advisors

To navigate the intersection of Section 409A and gift tax valuations effectively, advisors should adopt the following best practices:

- **Collaborate early:** Estate planners and compensation professionals should coordinate early in the planning process to align valuation strategies and avoid conflicting outcomes.
- **Engage qualified appraisers:** Use valuation professionals with experience in both Section 409A and gift tax contexts. Dual expertise ensures that the nuances of each regime are properly addressed.
- **Maintain clear documentation:** Keep detailed records of valuation assumptions, methodologies and the rationale for any differences between Section 409A and gift tax values.
- **Avoid one-size-fits-all approaches:** Tailor each valuation to its specific legal purpose. What works for Section 409A may not work for gift tax and vice versa.
- **Monitor IRS guidance and case law:** Stay current on IRS enforcement trends, court decisions and valuation best practices to ensure compliance and defensibility.

Risk or Opportunity?

As the use of equity compensation and sophisticated estate-planning techniques continues to grow, the intersection of Section 409A and gift tax valuations will remain a critical area for advisors to address. While there are opportunities to align these valuations for strategic benefit, significant pitfalls also exist that can lead to IRS scrutiny and adverse tax consequences.

Understanding the distinct purposes, standards and assumptions behind each valuation regime is essential. By coordinating efforts, engaging qualified

A Tale of Two Valuations

It's important to document the rationale for the method used

Scenario: A tech startup founder receives an Internal Revenue Code Section 409A valuation of \$12 per share in June. In July, she gifts \$1 million worth of shares to an irrevocable trust and uses the same \$12 value on her gift tax return.

Issue: IRC Section 409A valuations use allocation methods designed to comply with deferred compensation regulations and may not explicitly apply discounts for lack of control (DLOC) or lack of marketability (DLOM), which are essential considerations in gift tax valuations.

For example, a proper gift tax valuation would have applied a 25% DLOM and 15% DLOC, reducing the fair market value (FMV) to \$7.65 per share.¹

A proper gift tax valuation would determine the FMV of the startup as of the date of the transfer and then apply appropriate discounts, which could reduce the FMV per share.

Outcome: During the audit, the Internal Revenue Service disputed the valuation.

Lesson: Always tailor valuations to their legal purpose, and document the rationale for any assumptions or methodologies used.

Endnote

1. These figures are illustrative only; actual discounts must be supported by empirical studies and applied with care.

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professionals and maintaining robust documentation, advisors can bridge the gap between Section 409A and gift tax valuations, turning a potential compliance risk into a planning opportunity. ■

Endnotes

1. Internal Revenue Service Chief Counsel Memorandum 202152018 (Dec. 30, 2021) clarifies that outdated Internal Revenue Code Section 409A valuations ignoring pending mergers aren't suitable for gift tax purposes, www.irs.gov/pub/irs-wd/202152018.pdf.
2. For illustration purposes, discounts are shown sequentially; in practice, their application is more nuanced.