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How Changes In Regulation Have Driven Stock Option Prices

If you are an executive or a director of a private company, then you probably have heard about IRC 409A.[1] And you probably also know that failing to meet the requirements of IRC 409A can subject both your company and the employees who receive stock options to substantial tax penalties.

A convergence of tax and accounting rule changes is driving stock option prices much higher than venture capitalists and entrepreneurs expect.

What many people do not know is that this tax rule is not the only regulation to which stock options are subject. The other regulatory framework – financial accounting under GAAP [2] – also sets some tough requirements and can impose a high cost on your company for non-compliance.

For more than a decade, there has been a push by both sets of regulators – tax and financial accounting – to tighten the rules for stock option valuation and accounting. This has driven stock option prices higher.

We will discuss both regulatory frameworks, how they relate to one another, why stock option prices are much higher now than five or ten years ago, and outline a strategy which an emerging growth company can follow to remain in compliance – without losing the ability to issue stock options to attract and retain employees.

A Brief History of Stock Option Regulation

For the last several decades, emerging growth companies have competed with larger companies for employees by offering equity compensation. It is a tradeoff that is well known: longer hours for lower pay at a less financially stable company in return for an equity stake that may provide a substantial financial upside in the future.

For many years, emerging growth companies issued stock options at bargain prices to provide this equity upside. Since at least the creation of "qualifying stock options" in 1981,[3] the IRS has required that options be priced at or above the fair market value of the underlying stock. But, until recently, the IRS did not provide much guidance about how fair market value was to be calculated nor was it very active in enforcing the regulation (at least among private companies issuing stock options).

The tax advisors of emerging growth companies were aware of the IRS requirement and one reason that preferred stock emerged as the financing vehicle of choice for venture capital investments was that it separated the security used for funding (preferred stock) from the security used for compensation (common stock).[4] This allowed a company to argue with some plausibility that the fair market value of common stock was substantially less than the price obtained for preferred stock in an investment transaction.

Key Dates

1972 – APB 25, Accounting for Stock Issued to Employees

1981 – IRC 422, IRS creates incentive stock options

1995 – FAS 123, Accounting for Stock-Based Compensation

1990s – SEC objects to cheap stock, forces restatements

2003 – AICPA Practice Aid; Valuation of Privately-Held-Company Equity Securities Issued as Compensation

2004 – FAS 123R, Share-Based Payment

2005 – Jobs Creation Act; IRS proposes requirement for independent appraisal

2006 – Pension Protection Act; IRS defines “qualified appraisal” and regulates appraisers

2006 – FAS 157, Fair Value Measurements

2009 – IRC 409A goes into effect

2011-2012 – AICPA Practice Aid draft revisions published

Over time, a “rule of thumb” developed that the fair market value of common stock was approximately 10% of the price of the last round of preferred stock, a convention that was followed by the boards of most venture capital backed companies for the last several decades – despite the fact that it had no foundation in any valuation practice nor was it accepted by any authority.

The SEC Makes Its Displeasure Known

The SEC was the first regulator to systematically attack bargain pricing of stock options, including the 10% “rule of thumb.”[5] SEC staff members were uncomfortable with the large differences between the prices at which stock options were issued in the several years before an IPO and the ultimate IPO price.[6] They believed that companies were undervaluing equity securities issued to employees and that this was understating total compensation expense – in essence, lack of compliance with GAAP.

To correct this, the SEC began pursuing what came to be called cheap stock.

Especially during the IPO boom of the late 1990s, staff members delayed the registration of many companies with questions about option pricing and forced some of those companies to restate their financial results, taking large cheap stock charges in the process.[7] These enforcement activities got the attention of some companies and their advisors, but in reality only the relatively small number of companies which were close to an IPO changed their option pricing practices.

The FASB Tightens Its Option Accounting Rules

In 2004, the FASB announced a substantial revision to its rules governing financial accounting for stock options. The new rule, FAS 123R (now ASC 718),[8] standardized accounting methodology in a fairly rigorous fashion by requiring companies to determine the fair value of the common stock against which the option was being priced and to record compensation expense immediately when options were issued, even if the options were not yet in the money.[9] The rule went into effect for public companies in 2005 and for private companies in 2006.[10]

Despite the rigor of FAS 123R, there was no penalty if a company determined a different fair market value for tax purposes and fair value for accounting purposes (apart from having to book non-cash cheap stock charges), so many companies continued their historic practice of issuing stock options at low prices.

The IRS Moves to Enforce Its Price Rule

The situation changed when the IRS announced that it was tightening the tax rules governing stock options in 2005. Using a "carrot and stick" approach, IRC 409A offered a company which issues stock options the "carrot" of a safe harbor, if the company obtains an independent appraisal to determine the fair market value of the common stock,[11] and

Fair Market Value vs Fair Value

Why are there two very similar terms? And what is the difference between them?

Tax regulation, as administered by the IRS and state tax authorities, generally refers to fair market value, for tax purposes. The term was used in tax codes and by the courts for much of the 20th century, but it really came into its own with the publication in 1959 of Revenue Ruling 59-60.[14]

Accounting standards, as administered by the FASB (and the IASB[15]), generally refer to fair value, for financial accounting purposes. The term was utilized in a variety of Financial Accounting Standards, but formally codified in FAS 157 (now ASC 820).[16] At that time, the FASB stated that fair value was the same in many ways as fair market value, but without the 50 years of Tax Court cases which followed Revenue Ruling 59-60.[17]

threatened the "stick" of a penalty surtax (which, when combined with certain state taxes, could reach 60% to 90% of gains [12]), if the stock options were not priced at or above fair market value.

The FASB Clarifies Its Valuation Standard

Finally, in 2006, the FASB announced a rule, FAS 157 (now ASC 820), which standardized its definition of fair value for all accounting purposes and reaffirmed its intention to leave it consistent with the tax standard of fair market value.[13] FAS 157 also laid out a fair value hierarchy, which will be described further below.

The Effect of Regulation

For much of the last several decades, most companies did not worry much about stock option pricing. Boards of directors held option prices low (often relying on the 10% "rule of thumb"), unless they were planning to complete an IPO within a year or two (in which case they increased the price enough to try to avoid a cheap stock problem with the SEC).

The Initial "Land Rush" Triggered by IRC 409A

Things changed when the IRS announced IRC 409A in 2005. Suddenly, for the first time, there were rules about how the stock of a private company must be valued and penalties for failing to follow those rules.

At first some scoffed at the regulations and many companies were slow to adopt the new rules. That changed when the IRS followed its announcement of IRC 409A with subsequent drafts of the regulations and an implementation date.[18] Between 2007 and 2010, most companies decided that they had to conform, but they still attempted to obtain the lowest possible fair market value when pricing stock options.

What followed was something akin to an Old West land rush. A significant number of new people and firms declared that they were "valuation specialists" and offered to provide short-form IRC 409A valuation reports for very low fees, although many of them had no formal training in valuation.

The land rush was possible because it seemed that the IRC 409A rules were fairly loose: IRC 409A only requires that fair market value of common stock at the time of an option grant be "determined by the reasonable application of a reasonable valuation method."[19]

There is little guidance in IRC 409A (or, for that matter, elsewhere in the Internal Revenue Code and related publications) about what constitutes a "reasonable valuation method."[20] And IRC 409A sets a low threshold, stating that if a company obtains an "independent appraisal"[21] it creates a presumption that a "valuation method" or the "application of a valuation method" is "reasonable" unless the IRS shows that it is "grossly unreasonable."[22]

As one would imagine in a field which seems to have few barriers to entry, little guidance about methods, and shifts the burden of proof to the shoulders of the IRS, there was a lot of variation in the quality of reports. Many of the reports were hastily done and thinly supported. We refer to them as "short-form IRC 409A valuation reports."

A Higher Standard Required by the Audit Firms

Beginning in 2007 and gathering momentum in 2008 and 2009, the audit firms which serve technology and life science company clients began to object to the short-form IRC 409A valuation reports provided by many of the new self-declared "valuation specialists." (Audit firms are required by GAAP to review the determination of fair value at the time of stock option grants and periodically thereafter in order to monitor compliance with FAS 123R (now ASC 718),[23] so auditors must review the valuation reports their client companies obtain to support those stock option grants.[24])

The auditors found a number of problems in some of those short-form IRC 409A valuation reports, including: lack of understanding of basic valuation practices, improper application of valuation methods, reliance on faulty assumptions, inconsistency from period to period, and failure to incorporate data from the sale of preferred stock by the client company.

In some cases, auditors may calculate that the effect of relying on a problematic report is not financially material (typically because the resulting cheap stock charges were small). So, they note the problem and close the audit (often warning the client company that it will need to obtain a higher quality valuation report before the next audit).

In other cases, auditors determine that they cannot rely on a problematic report. They require the company to recalculate fair value at a higher level and book cheap stock charges; the difference between the option price which was set using the first, problematic value and the new, properly calculated value.

This whole process can create substantial problems for the company, especially if it is forced to reprice employee stock options at a higher value or – worse – if the problem is uncovered during the process of selling the company, when it can create an obstacle to the sale or an opportunity for the buyer to lower the price.[25]

IRS Enforcement, a Two-Pronged Attack – Warnings to Companies

Enforcement of tax regulations takes time. Because IRC 409A did not go into full effect until January 1, 2009 and because of the lengthy IRS appeal process,[26] there are not yet any published results from litigation involving stock options under IRC 409A. However, the IRS has provided some guidance, both at public meetings and in private calls to the Office of the Chief Counsel, about the direction of its enforcement activity.[27]

Specifically, the IRS has indicated that it is looking for several "red flag" issues, any one of which could trigger further scrutiny under IRC 409A. The three main issues seem to be: if the valuation report does not follow a recognized appraisal standard; if the person preparing the valuation report lacks appraisal credentials; and if the client company records cheap stock compensation expense charges.[28]

IRS Enforcement, a Two-Pronged Attack – Warnings to Appraisers

Almost unnoticed in all of this, the IRS quietly moved to include appraisers on its list of professionals whom it may regulate and sanction for their tax work. With authority obtained from Congress in 2006,[29] the IRS included appraisers in Circular 230, its regulation governing the practice of tax lawyers, certified public accountants, and others.[30]

The Problem of Cheap Stock Charges

The focus on cheap stock charges ties the tax enforcement policy of the IRS directly back to the accounting standards and audit practices required under GAAP. For example, if a company chooses to rely on a problematic IRC 409A valuation report to establish the fair market value of new stock options at $0.10 per share under the tax regulations and later is forced by its audit firm to record a higher fair value of $0.15 per share for the same purpose under the financial reporting regulations, it would have to record a cheap stock charge of $0.05 for each stock option issued.

Even if a million options had been granted, the non-cash cheap stock charge of $50,000 seems inconsequential (especially since it would be amortized over the vesting period of the stock options, typically four years). However, that cheap stock charge will be "red flag" to the IRS in a later audit if that company goes on to a successful IPO or acquisition. And the higher fair value recorded for GAAP purposes will be very helpful to the IRS in overcoming its burden of proof and showing that the problematic IRC 409A report was not reasonably prepared.

Continuing the example, assume that the stock was sold at an IPO or acquisition for $10.00 per share. Once the IRS established that the original option issue was below fair market value, it would have the power to assess tax on the employees who received those options, presumably at the 39.6% maximum personal rate plus a 20% penalty rate on the entire gain. California residents also would be assessed additional tax, presumably at the 10.3% maximum personal rate plus a 20% penalty rate.

For the first time, "qualified appraisal" and "qualified appraiser" were defined. In particular, the IRS focused on having appraisers follow "generally accepted appraisal standards"[31] and earning an "appraisal designation" from a "recognized professional appraisal organization."[32]

In the period since then, the IRS has opened more than one hundred cases against appraisers for violations of its standards[33] and the penalties are high.[34] The intention of the IRS is to push both for higher standards in valuation reports and greater professionalism among those who prepare these reports

Effect of Preferred Stock Financings on Stock Option Values

One of the most common problems with short-form, inexpensive IRC 409A valuation reports is that they often fail to include a value for the common stock calculated using the price of the last round of preferred stock issued by the client company (referred to as a back-solve).

Basic Requirements of the GAAP Rule

Many company managers and venture capital investors bristle at the concept of attempting to value common stock using a price for preferred stock. There are significant differences between the two types of stock: preferred stock often has dividends, liquidation preferences, anti-dilution protection, and redemption, plus rights to registration, co-sale, information, board seats, and even to veto certain actions by the company; common stock has none of these.

Nonetheless, the audit profession (and presumably the IRS[35]) has taken the position that the value of one class of stock can be deduced from a price obtained in a recent sale of another class of stock. The audit profession has no flexibility about this because of the wording of FAS 157.

Fair Value Hierarchy

Level 1 – quoted prices

Level 2 – other observable inputs

Level 3 – unobservable inputs

FAS 157 (now ASC 820), codifies a fair value hierarchy. It differentiates between observable inputs, such as a quoted stock price, and unobservable inputs, such as a company's financial projections, giving greater weight to observable inputs than to unobservable inputs.[36]

Under this fair value hierarchy, a value for common stock calculated using the price of a recent series of preferred stock will take precedence over a value for common stock calculated using discounted cash flows or market comparisons. There are exceptions, but they are limited: if the preferred stock transaction involves duress, related parties, or considerations other than just investment (e.g. a corporate partner invested and also obtained product rights).[37]

The Result – Higher Common Stock Values and Stock Option Prices

In many instances, the value of common stock based on the price of the preferred stock will be significantly higher than what other valuation methodologies indicate or what the company managers and board members expect

Framework for Tax and Audit Compliance

Given all of these rules and the inherent complexity of trying to balance the different standards of the tax and accounting regulatory systems, what should a private company do to stay in compliance – while still using stock options to recruit and retain employees? We think that there are a few straightforward principles to follow.

Obtain an Independent Appraisal

Both the IRS and and audit firms strongly prefer a report prepared by an outside expert, so bite the bullet and hire an independent appraiser.

Ensure that the Appraisal Follows a Recognized Standard

The IRS has said that it will concentrate its enforcement activities on reports which do not conform to an accepted standard. Obtain a commitment in writing from the appraisal firm that the valuation report will follow the guidelines of the AICPA Practice Aid and will adhere to the standards of USPAP.[38]

Ask if the Appraiser is Accredited

The IRS also has said that it will look harder at reports prepared by “valuation specialists” who lack credentials. Ask if your appraiser has “a designation from a recognized professional appraiser organization.”[39]

Check if the Appraisal Firm is Known by the Auditors

Especially if you use a Big Four audit firm, ask your audit partner if his or her internal valuation team knows of the appraisal firm. The review process will go more smoothly (and result in lower audit fees) if the appraiser understands the audit requirements and if the appraisal firm and auditor have worked together before.

Provide a Complete and Balanced View

When meeting with the appraiser to explain your company, provide a thorough and balanced understanding of the forces which work for – and against – your company. Remember, if your company is wildly successful, someone examining an appraisal a few years later will be judging it with 20:20 hindsight and you will want a full description of the risks and challenges your faced at the time to help defend what may seem like a low value.

Understand the Role of a "Prior Sale"

If your company has recently completed a financing, then the value implied by that financing must be used in a back-solve to determine the value of common stock for pricing stock options. Since the publication of FAS 157 (now ASC 820) there has been no flexibility about this. You may be able to find a "valuation specialist" who is willing to ignore the value implied by a "prior sale." But a later examination by the IRS or an auditor is going to reveal it – and lead to cheap stock charges or worse.

Notify the Appraisal Firm about Changes

Finally, keep the appraisal firm up to date about changes in your company. If there is a material change – a new financing, litigation, or results which are substantially better or worse than plan – it may be necessary to obtain a new valuation report. In any event, you will need a new valuation report no later than 12 months after the last valuation report.[40]

Teknos Associates provides valuation services for emerging growth companies and their venture capital backers. Clients rely on our financial expertise, knowledge of technology markets, and high standards to deliver relevant and timely valuation reports and fairness opinions.

Special Note: *From time to time, Teknos Associates has been retained by the Internal Revenue Service to perform valuation services. However, nothing in this communication may be taken to represent the official position or policy of the IRS. The opinions expressed herein are those only of Teknos Associates.*

IRS Circular 230 Disclaimer: *Pursuant to regulations governing the practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries, and appraisers before the Internal Revenue Service, unless otherwise expressly stated, any U.S. federal or state tax advice in this communication (including attachments) is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of (i) avoiding penalties that may be imposed under federal or state law or (ii) promoting, marketing, or recommending to another party any transaction or tax-related matter(s) addressed herein.*

1. The American Jobs Creation Act of 2004 authorized Internal Revenue Code §409A (IRC 409A).

2. Generally accepted accounting principles (GAAP). GAAP are the accounting rules used to prepare and present financial statements. Companies are not required by law to follow GAAP (unless they are publicly traded, in which case the US Securities and Exchange Commission (SEC) requires conformance), but most conform voluntarily. The Financial Accounting Standards Board (FASB) generally leads the setting of new accounting standards and has published an Accounting Standards Codification (ASC).

3. The Economic Recovery Tax Act of 1981 authorized IRC §422 (IRC 422) and defined the terms of tax-advantaged incentive stock options, including the requirement that "the option price [be] not less than the fair market value of the stock at the time such option is granted." IRC 422(b)(4).

4. Ronald J. Gilson and David Schizer, "Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock," Stanford Law and Economics Olin Working Paper No. 230, February 2002.

5. The FASB made an attempt to tighten the rules in 1993 when it published an Exposure Draft on the subject, but that effort was beaten back by pressure from industry and Congress.

6. Technically, SEC staff members initiate a discussion about "stock-based compensation" and ask for an explanation of the difference between the fair value of common stock as estimated by the company during the several year period before the planned initial public offering (IPO) and the mid-point of the estimated offering price contained in the Form S-1 filing. SEC staff members also routinely ask for a reconciliation of the fair value of common stock and the cash prices obtained for by the company in sales of preferred stock during that same period and for an estimate of the intrinsic value of all vested and unvested options based on the mid-point of the estimated offering price; both exercises can turn up valuation problems.

7. Michael J. Halloran and David R. Lamarre, "Identifying and Avoiding 'Cheap Stock' Problems, in Venture Capital and Public Offering Negotiation," Pillsbury Madison & Sutro LLP (now Pillsbury Winthrop Shaw Pittman LLP) website 1999.

8. FASB Statement of Financial Accounting Standards No. 123, Share Based Payment, revised (FAS 123R); now governed by FASB ASC 718, *Compensation – Stock Compensation* (ASC 718).

9. Until this time companies had accounted for options under the old rules of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), which did not require that a company record compensation expense unless the option price was less than the then-current stock price, and FASB Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (FAS 123, later replaced by FAS 123R), which "encouraged" companies to record compensation expense in the year options were issued, but allowed companies to continue to follow APB 25 so long as the more detailed disclosure was contained in a footnote to the financial statements.

10. A year earlier, in 2003, the American Institute of Certified Public Accountants (AICPA) published a practice aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the Practice Aid), about stock option pricing, an outgrowth of the SEC's earlier pursuit of cheap stock problems. The Practice Aid described the techniques used by valuation professionals and suggested which techniques were appropriate to emerging growth companies at various stages in their development. Over the next several years, this Practice Aid became the de facto accounting standard for producing an acceptable valuation report to support stock option issuance by a company.

11. Technically, a company issuing stock options has three alternatives to establish fair market value under IRC 409A: (a) independent appraisal; (b) binding formula (essentially a buy-sell agreement); or (c) internal appraisal. See Note 21, below. However, for the purposes of this white paper, we have concentrated our analysis on the alternative used by most venture capital-backed companies: independent appraisal.

12. IRC 409A requires an individual who received a stock option priced below fair market value to pay: (a) tax on the entire difference between the ultimate sale price less the original issue price (i) at the highest marginal tax rate (currently 39.6%) plus (ii) a 20% penalty tax; and (b) interest of (i) the IRS "late payment" rate plus (ii) 1% from (iii) the date of the option grant. California mirrors this arrangement for state taxes, including an additional 20% penalty tax.

13. See Note 17, below.

14. Revenue Ruling 59-60, 1959-1 Cumulative Bulletin 237 (Revenue Ruling 59-60).

15. International Accounting Standards Board, (IASB), the standard setting body responsible for creating international financial reporting standards (IFRS).

16. FASB Statement of Financial Accounting Standards No. 157, F*air Value Measurements* (FAS 157); now governed by FASB ASC 820, *Fair Value Measurements and Disclosures* (ASC 820).

17. Specifically, the FASB stated that "the measurement objective in the definition of fair value used for financial reporting purposes is generally consistent with similar definitions of fair market value used for valuation purposes. For example, the definition of fair market value in Internal Revenue Service Revenue Ruling 59-60 (the legal standard of value in many valuation situations) refers to 'the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.' However, the [FASB] observed that the definition of fair market value relates principally to assets (property). Further, the definition has a significant body of interpretive case law, developed in the context of tax regulation. Because such interpretive case law, in the context of financial reporting, may not be relevant, the [FASB] chose not to adopt the definition of fair market value, and its interpretive case law, for financial reporting purposes." FAS 157, paragraph C50 (italics added).

18. The initial guidance was published by the Internal Revenue Service (IRS) on December 20, 2004. The final regulations were published by the IRS on April 17, 2007 and they were to take full effect on January 1, 2008, but on September 10, 2007, interim relief was provided and the date for full effect was changed to January 1, 2009.

19. IRC 409A(b)(5)(iv)(B)(1).

20. IRC 409A goes on to say: "factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cashflows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the sale or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders, or its creditors." IRC 409A(b)(5)(iv)(B)(1).

21. A company may create a rebuttable presumption of reasonableness by following one of three paths: (a) independent appraisal; (b) binding formula (a formula established in a buy-sell agreement and used in other agreements and filings); or (c) internal appraisal (only available to a company which is less than 10 years old and does not anticipate an IPO in the next 180 days or a sale in the next 90 days, the report must be in writing, take into account the "general valuation factors" described in Note 20, above, and be performed by a person with "significant knowledge, experience, or training" in valuation, and "significant experience" is defined as "at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient [the issuing company] operates"). IRC 409A(b)(5)(iv)(B)(2).

22. IRC 409A(b)(5)(iv)(B)(2).

23. An auditor may not simply rely on an independent valuation report. AICPA Statement on Auditing Standards No. 73, *Using the Work of a Specialist* (SAS 73), lays out the requirements for relying such work. These include reviewing the specialist's credentials and experience and assessing the quality of the work performed.

24. There is a distinction between fair market value determined for tax purposes under IRC 409A and fair value for GAAP purposes under FAS 123R (now ASC 718), but that difference is slight and even auditors routinely disregard it. See Note 17, above.

25. See the Teknos white paper, *Acquirer Challenges Early IRC 409A Report,* http://www.teknosassociates.com/downloads/Acquirer_Challenges_Early_IRC_409A_Report.pdf and the Teknos article, *IRC 409A After Three Years: It's Not Just About Tax,* http://www.teknosassociates.com/index.php/news/page/irc-409a-after-three-years-its-not-just-about-tax/

26. In a dispute about taxes with the IRS, the matter can be appealed internally to the IRS Office of Appeals and then appealed again to US Tax Court, before a Tax Memo is published; the process can take several years.

27. Most notably, the IRS discussed these issues at the AICPA/ASA National Business Conference in November 2008. Of course, this IRS presentation began (and all similar presentations by representatives of the IRS begin) with a statement that the opinions offered are those of the individual representative and "may not reflect the position or policy of the IRS."

28. Representatives of the IRS have commented that there might be valid reasons for a divergence between fair market value determined for tax purposes and fair value for GAAP purposes (e.g. tax law recognizes a discount for lack of control in certain instances, whereas generally the SEC does not). However, representatives of the IRS have gone on to say that they would seek to understand the reasons for the differences in such cases.

29. Pension Protection Act of 2006 (PPA 2006).

30. Treasury Department Circular No. 230 (Circular 230), September 26, 2007.

31. See note 38, below.

32. PPA 2006, Title XII, Subtitle B, amending IRC §6695A(c)(1)(E)(i)-(ii).

33. The IRS Office of Professional Responsibility (OPR) was given the authority to pursue enforcement under IRC §6695A and periodically publishes bulletins about pending actions and sanctions on the IRS website.

34. The IRS can impose a civil penalty against an appraiser calculated as the lesser of: (a) the greater of (i) 10% of the amount of the underpayment or (ii) $1,000; or (b) 125% of the gross income received by the appraiser from the preparation of the appraisal. Plus the IRS can sanction the appraiser and bar him or her from practicing again before the IRS.

35. Some valuation professionals contend that the IRS does not require examination of prior sales of preferred stock under the principles of IRC 409A(b)(5)(iv)(B)(2). They dismiss the clause, "recent arm's length transactions involving the sale or transfer of such stock or equity interests," by inferring that "such stock" refers only to the same class of stock being valued. However, this flies in the face of a comment noted by the IRS in its discussion of this change in the final regulations: "[o]ne commentator requested that the factors to be considered in determining the fair market value of the stock should be modified to include consideration of *any recent equity sales made by the corporation* in arm's-length transactions. The final regulations adopt this suggestion." Department of the Treasury, 26 Code of Federal Regulations I, Application of Section 409A To Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, D.4.c.i., April 17, 2007 (emphasis added).

36. FAS 157 established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (a) Level 1 – Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets; (b) Level 2 – Observable inputs other than quoted prices included in Level 1 for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-driven valuations in which all significant inputs and significant value drivers are observable in active markets; and (c) Level 3 – unobservable inputs to the valuation derived from fair valuation techniques in which one or more significant inputs or significant value drivers are unobservable. Level 1 inputs take precedence over Level 2 and 3 inputs and Level 2 inputs take precedence over Level 3 inputs. FAS 157, paragraphs 22 to 30.

37. FAS 157, paragraphs 7 and 10.

38. Uniform Standards of Professional Appraisal Practice (USPAP), developed by The Appraisal Foundation, as "generally accepted appraisal standards," pursuant to The Financial Institutions Reform, Recovery and Enforcement Act of 1989, 12 United States Code 3331-3351.

39. Internal Revenue Bulletin, October 6, 2008, Qualified Appraiser.

40. IRC 409A(b)(5)(iv)(B)(2)(i); "A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations *as of a date that is no more than 12 months before the relevant transaction* to which the valuation is applied (for example, the date of grant of a stock option)" (emphasis added).