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RICHEY MAY Alternative Investments

409A VALUATION

The key to protecting your fund's earnings

At Richey May, we've always looked at valuation as a critical aspect of running a fund structure, from both an audit and tax perspective.

To dig deeper on the topic, we tapped our friends at **Houlihan Capital**, a leading valuation, financial advisory and investment banking firm based in Chicago. We came away with valuable insights on 409A valuations – what they are, when you need one and more.

1. What is a 409A valuation?

26 U.S. Code § 409A ("IRC 409A") is a tax rule that applies to companies offering **"nonqualified deferred compensation"** or compensation paid/received in a later tax year than the year it was earned. The IRS views stock options granted "in the money" as nonqualified deferred compensation and imposes potentially serious consequences for the recipient, including:

- Counting the spread between exercise price and fair market value as current year gross income
- Assessing an additional tax equal to 20% of the spread

A 409A valuation is an independent appraisal of the fair market value per share of a private company's common stock typically used to set the exercise price of granted options to avoid IRS penalties. The IRS will presume the valuation reflects fair market value and exclude the options from 409A restrictions, and the burden will shift to the IRS to show the valuation is grossly unreasonable.

2. When do you need a 409A valuation?

A company needs a 409A valuation before it issues common stock options. Valuations are valid for a maximum of 12 months or until a material event occurs. It's common for companies to seek a 409A valuation after raising a round of venture financing or before an IPO, merger or acquisition.

3. Who does Section 409A apply to?

IRC 409A applies to anyone subject to U.S. federal income taxation who is potentially receiving nonqualified deferred compensation, including U.S. tax residents and nonresidents of the United States who earn U.S.-source compensation.

4. How is a 409A valuation determined?

An independent 409A appraiser should follow generally accepted principles of business valuation, specifically traditional techniques, methods and models used under the **three broad approaches to value:** 1) the income approach, 2) the market approach, and 3) the cost (net asset) approach.

Early-stage companies often narrow the valuation to application of the market approach via a **"backsolve" technique** that leverages a recent financing round. In these cases, the appraiser can perform a 409A analysis with minimal documentation and input from the company's management and produce the valuation report quickly, efficiently and affordably.

For more information on 409A valuations or the services Richey May provides to the alternative investments industry, please contact **Steve Vlasak**.