

**Simple Guide to 409a**  
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Section 409a was added to the Internal Revenue Code on January 1, 2005. However, as with many such regulations the actual “effective date” of 409a regulation was January 1, 2007. Since then, companies that grant deferred compensation, i.e. options, must comply with Section 409a.

Section 409a is very complicated and generally provides that deferred compensation must comply with various rules regarding the timing of deferrals and distributions. In most private company cases the main concern is not to fall under Section 409a by issuing qualified deferred compensation stock options at or above FMV (Fair Market Value) under “safe harbor” methods. IRS provides three “safe harbor” methodologies:

1. Independent Appraisal Presumption.

A valuation performed by a qualified independent appraiser, such as Greener Ventures, using traditional appraisal methodologies will be presumed reasonable if it values the stock as of a date that is no more than 12 months before the applicable stock option grant date. The key words here are independent, qualified and within 12 months. If these requirements are met, the burden is on IRS to prove the valuation was “grossly unreasonable.”

2. Illiquid Start-up Presumption.

This methodology applies to private companies that are less than 10 years old, are not anticipating sale, IPO or change of control within the next 12 months and the stock is not subject to a put or a call right (this is not common for startups, but check with your attorney). If the CEO cannot be absolutely sure the company satisfies all these requirements, the company must use other valuation methodologies. Additionally, the valuation will be considered reasonable by IRS, if it is in written form, performed within 12 months of an option grant and performed by a person with significant knowledge and experience or training in performing similar valuations.

3. Binding Formula Presumption.

This valuation method must be based on consistent application of a single formula and used for all transactions, i.e. both for grant of stock and options, purchases or sales of stock to third parties, conversion of loans into stock, etc. The easiest way to understand this method is as a multiple of some tangible benchmark, such as Sales, EBITDA or Net Income.

When issuing options a private company must use one of the above three “safe harbor” methods to put the burden of proof on IRS. If the valuation is performed outside of “safe harbor” the burden of proof falls on a taxpayer. The penalties for Section 409a violations are severe and include immediate tax on vesting, additional tax of 20% and penalty interest.

Of the three “safe harbor” methods the most practical and advisable is the independent appraisal methodology. From our discussions with corporate attorneys over 70% of VC or angel backed startups currently use independent appraisal method. The others either ignore the issue or conduct the internal valuation.



The simplest and cleanest solution to 409a is to hire an independent qualified valuation expert to perform FMV analysis and write a valuation report. Working with an independent qualified firm that knows how to value your unique business can be critical to obtaining a supporting valuation. At the very least a private company should obtain a person with significant knowledge and experience or training in performing similar valuations to conduct an internal FMV valuation and write a valuation report.

### **About Greener Ventures, LLC**

Greener Ventures is a leading provider of IRC 409A and ASC 505/718 (previously FAS 123R) valuation services to growing private companies. Greener Ventures has performed numerous 409a valuations since Section 409a was added to the Internal Revenue Code over five years ago. We work with leading law firms, accountants, venture capital firms and their portfolio companies. Big Four accounting firms such as Ernst & Young and leading regional accounting firms such as Tanner LC endorsed our 409a valuations.

For more information on Section 409a and other valuation and advisory services, please contact Greener Ventures, LLC at [info@greenerventuresllc.com](mailto:info@greenerventuresllc.com) or 801-502-8859.