February 27, 2006

Hon. Mark W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re:  Stock Rights and Service Recipient Stock under IRC Section 409A Proposed Regulations

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 409A Proposed Regulations concerning Stock Rights and Service Recipient Stock. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin  
Chair, Section of Taxation

Enclosure

cc:  Donald L. Korb, Chief Counsel, Internal Revenue Service  
     Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury  
     Michael J. Desmond, Tax Legislative Counsel, Treasury  
     Carol Gold, Internal Revenue Service, TEGE Employee Plans  
     Nancy Marks, IRS Chief Counsel, CC: TEGE  
     W. Thomas Reeder, Acting Benefits Tax Counsel, Department of Treasury  
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     Bill Bortz, Office of Benefits Tax Counsel, Department of Treasury  
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COMMENTS ON PROPOSED REGULATIONS UNDER CODE SECTION 409A REGARDING STOCK RIGHTS AND SERVICE RECIPIENT STOCK

The following comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the comments should not be construed as representing the position of the American Bar Association.

These comments were prepared by individual members of the Employee Benefits Committee of the Section of Taxation. Principal responsibility was exercised by Carol A. Weiser. Substantive contributions were made by William D. Jewett and Pamela Baker. The comments were reviewed by Greta E. Cowart, Chair-Elect and James R. Raborn, Chair of the Section’s Employee Benefits Committee; by the Quality Assurance Group of the Employee Benefits Committee, which is chaired by Thomas R. Hoecker and whose members are former chairs of the Committee; by T. David Cowart of the Section’s Committee on Government Submissions; and by Thomas A. Jorgensen, Council Director for the Employee Benefits Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. One of the participants has submitted comments on the proposed regulations under Section 409A on behalf of a client. However, those comments involve aspects of Section 409A not addressed by these comments, and these comments were not in any manner influenced by that work.

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Date: February 17, 2006
COMMENTS ON PROPOSED REGULATIONS UNDER CODE SECTION 409A REGARDING STOCK RIGHTS AND SERVICE RECIPIENT STOCK

I. EXECUTIVE SUMMARY

The following comments are submitted in response to the request for comments made by the Internal Revenue Service (“Service”) in the Notice of Proposed Rulemaking, 70 Federal Register 57930 (October 4, 2005), published with proposed regulations issued under Section 409A of the Internal Revenue Code of 1986, as amended (“Code”). These comments relate to issues arising under Proposed Treasury Regulations §§ 1.409A-1 through -6 regarding stock rights and service recipient stock, but not including issues related to valuation of service recipient stock, modification of stock rights and certain other issues.

Our recommendations are as follows:

1. We recommend that the Regulations, as finalized, adopt a safe harbor (the “Proposed Safe Harbor”) defining “service recipient stock” for service recipients that seek to grant stock rights that will not be subject to Section 409A. Under the Proposed Safe Harbor, service recipient stock would include any class of stock that would not be preferred stock for purposes of Section 305(b)(4) as of the date the stock right is granted, provided that either:

   (a) a substantial portion (at least 20%) of the outstanding shares of that class of stock is held by persons who acquired such shares other than in connection with the performance of services, or

   (b) stock of that class represents a substantial portion (at least 20%) of the value of all stock of the service recipient acquired other than in connection with the performance of services.

We also recommend that the Regulations, as finalized, incorporate a rule that will apply if a service recipient grants rights in a unit of equity interest comprised of shares of multiple classes of stock. We recommend that such a unit of equity interest be treated as service recipient stock to the extent that the unit would qualify under the safe harbor definition of service recipient stock if it were a single security.

2. We recommend that the Regulations, as finalized, further define the term “service recipient stock” in a manner that allows a member of a controlled group treated as a single service recipient under the Proposed Regulations to issue stock rights for the publicly traded stock of any member of the controlled group or to issue stock rights with

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1 All references herein to a “Section” shall be to a section of the Internal Revenue Code of 1986, as amended, unless explicitly stated otherwise.
2 All references herein to the “Proposed Regulations” shall be to the respective sections in Proposed Treasury Regulations §§ 1.409A-1 through -6, or to such Proposed Regulations as a whole. All references herein to the “Preamble” shall be to the preamble to the Proposed Regulations as set forth in 70 Fed. Reg. 57930 (Oct. 4, 2005).
respect to stock of any member of the controlled group that meets either the Proposed Safe Harbor or the alternative standards described herein, if the member does not have publicly traded stock. This definition will permit the issuance of stock rights for stock of an entity in the controlled group whose value meaningfully relates to both the services being performed by the service provider and to the value of the service recipient’s stock. If the Service believes that further constraints may be appropriate to limit any potential for abuse, we recommend that the Regulations, as finalized, incorporate one of two alternative conditions described below. Finally, we recommend that the language in Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(2) be revised in the Regulations, as finalized, to make it clear that a stock right can be granted on stock of a parent or intermediary holding company of other corporations in a controlled group.

3. We recommend that the Regulations, as finalized, provide that a stock right granted in good faith reliance on the statute and Notice 2005-1, 2005-2 I.R.B. 274 (Jan. 10, 2005) (“Notice 2005-1”) prior to the effective date of final regulations be treated as exempt from Section 409A when granted and continue to be treated as exempt from Section 409A after the effective date of the final regulations.

4. We recommend that the Regulations, as finalized, provide that a right to dividend equivalents or similar payments associated with shares underlying a stock right need not be set forth in a separate instrument in order to avoid causing the stock right to be subject to Section 409A, as long as the amounts are not payable upon exercise of the stock right.

5. We recommend that the Regulations, as finalized, clarify, by means of a specific cross-reference, that the term “corporate transaction” as used in Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(3) means a “corporate transaction” as that term is used in Treasury Regulation § 1.424-1(a)(3).

6. We recommend that the Regulations, as finalized, incorporate several rules to clarify the application of Proposed Regulations § 1.409A-1(b)(5)(iii)(D) permitting use of a threshold of either 50% or 20%, rather than 80%, for determining “stock of the service recipient” with respect to which stock rights may be granted. Specifically, we recommend that the Regulations, as finalized, provide that, in cases in which the service recipient elects to use the 20% threshold, the Regulations, as finalized, do not require the service recipient to demonstrate that there are legitimate business criteria for granting stock rights to any individual who provides service to an entity meeting the 50% ownership threshold. The Regulations, as finalized, should also clarify that the 20% threshold may be elected for a group and applied with respect to any businesses for which there are legitimate business criteria for doing so, even if the service recipient may not have legitimate business reasons for granting stock rights to employees of other entities that meet the 20% ownership threshold. Finally, the Regulations, as finalized, should clarify that an entity included as a service recipient with one group of businesses on the basis of the designation of either a 50% or a 20% threshold by that group could also be included as a service recipient with another entity, group of entities or multiple groups of entities based on similar designations by those entities.
II. BACKGROUND

We commend the Service for providing many useful clarifications in the Proposed Regulations with respect to the treatment of stock options and stock appreciation rights (“stock rights”). The Proposed Regulations also impose several new substantive requirements, however. We have questions regarding some of these requirements and concerns that others may not reflect the legislative intent with respect to stock rights.

The Conference Report to the American Jobs Creation Act (the “Conference Report”) states that the term “nonqualified deferred compensation plan” is not intended to include “an option on employer stock with an exercise price that is not less than the fair market value of the underlying stock on the date of grant if such arrangement does not include a deferral feature other than the feature that the option holder has the right to exercise the option in the future.”  

The initial guidance regarding Section 409A formulated an exception for stock options in similar terms:

An option to purchase stock of the service recipient, other than an incentive stock option described in § 422 or an option granted under an employee stock purchase plan described in § 423, does not provide for a deferral of compensation if: (1) the amount required to purchase stock under the option (the exercise price) may never be less than the fair market value of the underlying stock on the date the option is granted, (2) the receipt, transfer or exercise of the option is subject to taxation under § 83, and (3) the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7.

The basic concepts underlying this rule – that a compensatory option will be treated as nonqualified deferred compensation unless it is exercisable for “stock of the service recipient” and its exercise price may never drop below the fair market value of such stock – capture the objectives stated in the Conference Report.

III. COMMENTS

A. Definition of Service Recipient Stock – Proposed Safe Harbor

1. Summary

The Proposed Regulations limit the exception from Section 409A for stock rights on service recipient stock to stock “the fair market value of which meaningfully relates to the potential future appreciation in the enterprise value of the corporation,” to prevent the use of designer equity “created for the purpose of compensating service providers.” We agree that

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4 Notice 2005-1, Q&A-4(d)(iii).
such a limitation is consistent with the legislative intent of Section 409A. However, the operative language of the Proposed Regulations excludes a far broader range of stock from the definition of service recipient stock than is warranted by, or necessary to address, this concern. In particular, the broad prohibition in the Proposed Regulations on the use of preferred stock may, when combined with the other limits on the definition of service recipient stock, preclude some companies from granting stock rights. We propose a safe harbor based on rules issued under Section 305 that will provide a workable standard for identifying a class of stock that may be treated as service recipient stock for purposes of Section 409A.

2. **Recommendation**

We recommend that the Regulations, as finalized, adopt a safe harbor defining “service recipient stock” for service recipients that seek to grant stock rights that will not be subject to Section 409A. Under the Proposed Safe Harbor, service recipient stock would include any class of stock that would not be preferred stock for purposes of Section 305(b)(4) as of the date the stock right is granted, provided that either:

(a) a substantial portion (at least 20%) of the outstanding shares of that class of stock is held by persons who acquired such shares other than in connection with the performance of services, or

(b) stock of that class represents a substantial portion (at least 20%) of the value of all stock of the service recipient acquired other than in connection with the performance of services.

We also recommend that the Regulations, as finalized, incorporate a rule that will apply if a service recipient grants rights in a unit of equity interest comprised of shares of multiple classes of stock. We recommend that such a unit of equity interest be treated as service recipient stock to the extent that the unit would qualify under the safe harbor definition of service recipient stock if it were a single security.

3. **Explanation**

As noted above, the Conference Report provides that the term “nonqualified deferred compensation plan” is not intended to include an option on employer stock granted at fair market value if the option includes no deferral feature other than the right to exercise the option in future. The Preamble, however, formulates the exception for stock rights far more narrowly, importing limitations into the general definition of “stock of the service recipient” that appear to go well beyond a concern over potential abuses. The Preamble states:

The Treasury Department and the IRS believe that this exception was intended to cover stock rights with respect to service recipient stock the fair market value of which meaningfully relates to the potential future appreciation in the enterprise value of the corporation. The use of a separate class of common stock created for the purpose of compensating service providers, or the use of preferred stock with substantial characteristics of debt, could create an arrangement that more closely resembles
traditional nonqualified deferred compensation arrangements rather than an interest in appreciation of the value of the service recipient. An exception that excluded these arrangements from coverage under Section 409A would undermine the effectiveness of the statute to govern nonqualified deferred compensation arrangements, contrary to the legislative intent.\(^7\)

The Preamble goes on to say that the Proposed Regulations “clarify” that service recipient stock includes “only common stock, and only the class of common stock that as of the date of grant has the highest aggregate value of any class of common stock of the corporation outstanding, or a class of common stock substantially similar to such class of stock (ignoring differences in voting rights).”\(^8\) Moreover, service recipient stock is defined so as to exclude “any stock that provides a preference as to dividends or liquidation rights.”\(^9\) These new restrictions are set forth in Proposed Regulations § 1.409A-1(b)(5)(iii)(A).

Notice 2005-1 uses the term “stock of the service recipient,” as the Conference Report uses the term “employer stock,” to refer to all classes of capital stock issued by a service recipient. See, e.g., Q&A-10(b) of Notice 2005-1 (subjecting a risk of forfeiture to special substantiality tests “where the service provider owns a significant amount of the total combined voting power or value of all classes of stock of the service recipient corporation.”). The legislative history and the initial guidance thus appear to contemplate that Section 409A will include an exception for options on any class of service recipient stock because neither the legislative history nor the initial guidance limit the definition of “stock of the service recipient.”\(^10\)

We believe it is inconsistent with the objectives of Section 409A, and unnecessary as an anti-abuse measure, to treat stock rights on a broad range of ordinary equity securities as nonqualified deferred compensation solely because specific arrangements using a limited group of special-purpose securities could produce results similar to nonqualified deferred compensation. The definition of service recipient stock in the Proposed Regulations is far narrower than is necessary to deter the use of designer equity to avoid the requirements of Section 409A. The restrictive definition in the Proposed Regulations would substantially impair the ability of many companies to provide equity-based compensation that aligns the interests of service providers with those of shareholders.

The Proposed Regulations provide that only the class of stock that has the highest aggregate value at the time a stock right is issued (or a class of stock having substantially similar rights) may be treated as service recipient stock. The Proposed Regulations also provide that service recipient stock does not include any class of stock that has a preference as to liquidation or dividend rights. These restrictions are particularly burdensome for private companies, which

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\(^7\) 70 Fed. Reg. 57930, 57934 (Oct. 4, 2005).
\(^8\) 70 Fed. Reg. 57930, 57934 (Oct. 4, 2005).
\(^10\) CONF. REPT. at 735; GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, Staff of the Joint Committee on Taxation, JCS-5-05, May 2005, at 475; and Notice 2005-1, 2005-2 I.R.B. 274 at 275 and Q&A 4 and 5 (January 10, 2005).
are often capitalized with more than one class of common stock for valid non-compensatory business reasons.

Under the Proposed Regulations, a private company capitalized with common stock of two classes, where one class has liquidation or dividend preference features and also participates in the equity upside potential of common stock, while the other class has only the value associated with future equity growth, may have no class of stock that constitutes service recipient stock. If the common stock with the preference feature is the class with the highest aggregate value, it would be disqualified because of the preference feature, while the remaining common stock would be disqualified because it is not the class with the highest value. Such a company would be unable to compensate its service providers with tax-effective stock rights. This result would constrain the ability of U.S. companies and their investors to establish the capital structures that best serve their non-compensatory business purposes.

Neither Section 409A nor the legislative history includes any indication that this result was intended. The purpose of Congress in enacting Section 409A was to codify rules relating to the timing of income inclusion and to deter specific compensatory practices, not to impose new constraints on the capitalization of U.S. business enterprises. To carry out the legislative intent without unnecessarily constraining noncompensatory business decisions, narrowly crafted restrictions should be preferred over sweeping prohibitions.

The Preamble provides persuasive reasons for requiring that service recipient stock be meaningfully related to future appreciation in a company’s enterprise value, but the Proposed Regulations themselves do not provide a useful test for determining whether this standard is met. However, Section 305 and regulations thereunder include a familiar and serviceable test that is used for determining when a distribution is made with respect to stock “that does not participate in corporate growth to any significant extent.” Under this facts-and-circumstances test, stock is considered “preferred” for purposes of Section 305(b)(4) (relating to distributions on preferred stock) if “it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest.” Treasury Regulation § 1.305-5 sets forth a list of specific factors to be considered in making this determination, including “prior and anticipated earnings per share, the cash dividends per share, the book value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation.” A safe harbor incorporating this test – modified to refer to “the time a stock right is granted (or deemed to have been granted)” – would give the Service an administrable rule for identifying abusive stock rights, while permitting companies to rely on the standard that already guides important decisions relating to capital structure and distributions.

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11 CONF. REPT. at 735; GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, Staff of the Joint Committee on Taxation, JCS-5-05, May 2005, at 475; and Notice 2005-1, 2005-2 I.R.B. 274 at 275 and Q&A 4 and 5 (January 10, 2005).

12 Treasury Regulation § 1.305-5(a).
In furtherance of the objective of deterring use of “designer equity” to circumvent the requirements of Section 409A, we recommend that the Proposed Safe Harbor be available only for stock rights with respect to a class of stock if, at the time of grant, one of the two 20% tests set forth in the recommendation above is met. Such a requirement would facilitate enforcement by adding a bright-line threshold test that can be applied without inquiring into facts and circumstances. It would also further ensure that the value of the stock right is meaningfully related to the value of stock held by investors.

We recommend that the Regulations, as finalized, adopt the standard set forth in Treasury Regulation § 1.305-5 as a safe harbor because we believe that stock rights with respect to certain types of “preferred” stock (within the meaning of Section 305(b)(4)) may, under certain circumstances, bear little resemblance to traditional nonqualified deferred compensation. Taxpayers who hold stock rights with respect to stock that is substantially held by investors but that does not satisfy the Proposed Safe Harbor should be given the opportunity to establish, by clear and convincing evidence, that the purpose and effect of the stock right is not abusive. A similar opportunity should be available where a service recipient issues stock rights on common stock that has no preferences but that is not substantially held by investors.

Some companies with a capital structure involving several classes of stock may wish to align the interests of their employees or other service providers more closely with the interests of investors by granting to the service providers stock rights on a unit consisting of several classes of qualifying stock, which may be issued by a single company or by affiliated companies. Other companies might best achieve this objective by issuing stock rights on a unit consisting of several classes of stock (common and preferred) which, taken together, would be functionally equivalent to qualifying stock. We recommend that the Regulations, as finalized, provide that stock rights on units in such cases should also be treated as rights with respect to stock of the service recipient.

B. Definition of Service Recipient Stock.

1. Summary

As noted above in the discussion of the Proposed Safe Harbor, we acknowledge the Service’s legitimate concerns regarding the potential for use of “designer equity” to avoid the application of Section 409A. Specifically, we recognize the Service’s efforts to address potentially abusive arrangements through the inclusion of various provisions in the Proposed Regulations, such as the investment vehicle exclusion from the definition of service recipient set forth at Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(2) and the restriction against the use of special classes of stock. These anti-abuse provisions, as modified to incorporate the safe harbor recommended above, will help ensure that potentially abusive equity compensation arrangements will not circumvent the Section 409A rules. We believe, however, that the restrictive definition of “service recipient stock” included in the Proposed Regulations as it relates to service recipients that are members of a controlled group would either expand the reach of Section 409A beyond what was intended for stock rights or would hamper the ability of some service recipients that are members of a controlled group to develop effective plans for granting stock rights. We are particularly concerned that the Proposed Regulations and the definition of “service recipient stock” could be interpreted in a manner that would preclude employers from maintaining bona
fide equity compensation arrangements that are merely intended to provide appropriate incentives for their employees. In our view, the concerns the Service may have regarding abusive equity compensation arrangements can be adequately addressed without resorting to a rule that has such a prohibitive effect.

2. **Recommendation**

   We recommend that the Regulations, as finalized, further define the term “service recipient stock” in a manner that allows a member of a controlled group treated as a single service recipient under the Proposed Regulations to issue stock rights for the publicly traded stock of any member of the controlled group or to issue stock rights with respect to stock of any member of the controlled group that meets either the Proposed Safe Harbor or the alternative standards described herein, if the member does not have publicly traded stock. This definition will permit the issuance of stock rights for stock of an entity in the controlled group whose value meaningfully relates to both the services being performed by the service provider and to the value of the service recipient’s stock. If the Service believes that further constraints may be appropriate to limit any potential for abuse, we recommend that the Regulations, as finalized, incorporate one of two alternative conditions described below. Finally, we recommend that the language in Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(2) be revised in the Regulations, as finalized, to make it clear that a stock right can be granted on stock of a parent or intermediary holding company of other corporations in a controlled group.

3. **Explanation**

   Proposed Regulations § 1.409A-1(b)(5)(iii)(A) defines service recipient stock, in relevant part, as follows:

   > Except as otherwise provided in paragraphs (b)(5)(iii)(B) and (C) of this section, for purposes of this section, stock of the service recipient means stock that, as of the date of grant, is common stock of a corporation that is a service recipient (including any member of a group of corporations or other entities treated as a single service recipient) that is readily tradable on an established securities market, or if none, that class of common stock of such corporation having the greatest aggregate value of common stock issued and outstanding of such corporation, or common stock with substantially similar rights to stock of such class (disregarding any difference in voting rights). (Emphasis added)."\(^\text{13}\)

   The language highlighted above appears to require that if an employer or other service recipient is a member of a group of corporations that are treated as a single recipient under Proposed Regulations § 1.409A-1(g) (i.e., the “controlled group”),\(^\text{14}\) the employer may issue

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\(^{13}\) 70 Fed Reg. 57930, 57960 (Oct. 4, 2005).

\(^{14}\) Proposed Regulations § 1.409A-1(g) defines “service recipient” as “the person for whom the services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under section 414(b) (employees of controlled group
stock rights for the publicly traded stock of any member of the controlled group, but must use publicly traded stock if there is at least one member of the group that has publicly traded stock. For a controlled group none of whose members have publicly traded stock, the language can be interpreted to provide that any member of the group may issue stock rights only for the class of common stock of the one member of the group that has a class of common stock having the greatest aggregate value among all members of the controlled group. Alternatively, the language can be read to provide that, as long as no member of the controlled group has publicly traded stock, then a member of the group may issue stock rights with respect to the class of common stock of any member of the controlled group having the highest aggregate value.

Thus, the Proposed Regulations provide that non-publicly traded stock cannot be treated as service recipient stock if there is any corporation in the controlled group with publicly traded common stock, and the Service and Treasury have indicated in public statements that the Proposed Regulations require the use of publicly traded stock of a member of a controlled group if any member of the group has publicly traded stock. In addition, if there is no entity in the controlled group with publicly traded common stock, the Proposed Regulations may be read as permitting the stock of only one entity in the controlled group to be “service recipient stock,” although we believe the better interpretation would allow the stock of any corporation in the controlled group to qualify as service recipient stock, provided that stock rights are granted on the class of the corporation’s common stock with the highest aggregate value. We recommend, however, that the term “service recipient stock” should be defined in the Regulations, as finalized, in a manner that allows employers to establish bona fide equity compensation arrangements that are intended to align the value of stock right grants with the employees’ services and shareholder interests.

In many instances, requiring an employer to issue stock rights with respect to a publicly traded member of the controlled group (or with respect to the member having the class of common stock with the greatest aggregate value) will result in the issuance of stock rights that do not meaningfully relate to the value of the employer’s stock and bear little relationship to, or provide insufficient incentive for, the employee’s efforts. For example, if a publicly traded corporation has a number of direct and indirect subsidiaries engaged in different lines of business, under the Proposed Regulations, a subsidiary employer would not be permitted to issue stock rights with respect to its own stock and would be able to issue stock rights only as to stock of the publicly traded parent corporation. Requiring the use of this stock could significantly dilute the incentive value of the stock rights, which is the purpose for issuing the stock rights. The difficulty is even more acute in the case of a foreign parent (whether or not publicly traded in the U.S.) or a privately held parent with disparate U.S. businesses, some of which may have publicly traded stock. As a result of the lack of public disclosure regarding the holdings of the parent, employees of some of the U.S. subsidiaries may not even know of the existence of the

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15 See, e.g., 2005 TNT 194-6 (Oct. 7, 2005) (comments made by Daniel Hogans, attorney-adviser with the Treasury’s Office of Benefits Tax Counsel); 2005 TNT 202-5 (Oct. 20, 2005) (same). We have assumed that if there is more than one entity in a controlled group that has publicly traded common stock, then the publicly traded common stock of any such entity will qualify as service recipient stock under any reading of the Proposed Regulations.
other (brother-sister) businesses. If the only publicly traded stock in the controlled group is stock of a subsidiary, then it would be counter to good compensation policy to permit (let alone require) the employees of a brother-sister corporation in an unrelated line of business to be compensated in stock of the brother-sister subsidiary simply because it happens to be publicly traded. The compensation-policy concerns are analogous if there is no publicly traded stock in the controlled group and the stock of another entity is required to be used solely because it has the greatest aggregate value.

To align stock rights properly with the value of the employer, the term “service recipient stock” should be defined in a manner that would permit employers organized as a controlled group to issue stock rights in stock of an entity whose value meaningfully relates to the value of the stock of the service recipient for whom the service provider actually provides services. Often, this will not be the stock of the publicly traded parent or brother-sister entity within a controlled group, but a different entity, the value of which is more closely related to the value of the employer’s stock (e.g., a lower tier member of the group). A service recipient should be able to tailor the stock rights that it provides to its service providers to align the value of the equity compensation with the service recipient’s financial performance and, thus, maximize the incentives that are offered to service providers. We believe that the definition of “service recipient stock” recommended above would allow service recipients to tailor their grants of stock rights in this manner and that doing so is consistent with the legislative history of Section 409A. To limit any potential for abuse, however, the Service may also wish to include some restrictions in the final Regulations similar to those suggested below.

Specifically, the Service may wish to limit the granting of stock rights that are not subject to Section 409A by including in the Regulations, as finalized, an express requirement that stock rights may be granted with respect to stock that is not publicly traded only if the right meaningfully relates to the appreciation in value of the stock of the common law employer or service recipient for whom the service provider performs services, without regard to the controlled group rule. This restriction could be relevant in a situation in which, for example, the employer is only one of many operating companies in the controlled group and the business and operations of the employer’s brother-sister companies do not relate in a meaningful way to the business and operations of the employer. In these circumstances, it may be appropriate to limit the definition of service recipient stock by excluding non-publicly traded stock of a member of the controlled group whose value does not meaningfully relate to the value of the actual employer’s or other service recipient’s stock. For this purpose, stock of a member of the controlled group should be deemed to meaningfully relate to the value of the employer if the member is in the same direct chain of ownership as the common law employer.

Alternatively, the Service may wish to limit the definition of service recipient stock by permitting an employer to grant stock rights with respect to a non-publicly traded stock of a member of the controlled group other than the common law employer only if the grant of that stock is based upon legitimate business criteria. The requirement that an employer grant stock rights with respect to the common stock of an controlled group member based on legitimate business criteria is consistent with the definition of “service recipient” set forth in Proposed Regulations § 1.409A-1(b)(5)(iii)(D).
Finally, as indicated above, we believe that the anti-abuse measure with respect to investment vehicles set forth in Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(2) is appropriate; however, the language of that rule is potentially confusing and we recommend that it be revised in the Regulations, as finalized, to make it clear that a stock right can be granted on stock of a parent or intermediary holding company of other corporations in a controlled group.

C. Definition of Service Recipient Stock – Transition Relief

1. Summary

Proposed Regulations § 1.409A-1(b)(5)(iii)(E) provides relief for stock rights granted on classes of stock that do not satisfy the definition of service recipient stock; however, that relief is narrowly limited to rights granted on or before December 31, 2004, and it is not available to service providers of the many service recipients that in good faith have granted stock rights after 2004 with respect to stock that does not satisfy the restrictive definition of service recipient stock set forth in the Proposed Regulations.

2. Recommendation

We recommend that the Regulations, as finalized, provide that a stock right granted in good faith reliance on the statute and Notice 2005-1 prior to the effective date of final regulations be treated as exempt from Section 409A when granted and continue to be treated as exempt from Section 409A after the effective date of the final regulations.

3. Explanation

Proposed Regulations § 1.409A-1(b)(5)(iii)(E) provides, with respect to common stock: “[n]otwithstanding the requirements of paragraph (b)(5)(iii)(A) of this section, any class of common stock of the service recipient with respect to which stock rights were granted to service providers on or before December 31, 2004, is treated as service recipient stock for purposes of this paragraph (b)(5)(iii), but only with respect to stock rights granted on or before December 31, 2004.”16 Companies, relying reasonably and in good faith on the statute and initial guidance, may have issued stock rights with respect to stock that would not be treated as service recipient stock under the Proposed Regulations. Service providers and service recipients need to understand as soon as possible what treatment will apply to such grants and what courses of action will be available.

The Preamble states that if a provision of the Proposed Regulations (or the final regulations) is inconsistent with a provision of Notice 2005-1, a plan can satisfy the good faith compliance requirement prior to 2007 by complying with either provision.17 However, it is not clear whether it is necessary to follow the Proposed Regulations with respect to the new rules relating to service recipient stock that have no corresponding provision in Notice 2005-1, or whether it will be necessary to conform grants made after December 31, 2004 to final

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regulations. The Preamble states that the narrow rules defining service recipient stock in the Proposed Regulations merely “clarify” prior guidance; however, we believe that many service recipients and practitioners view these rules as more than a mere clarification. In any event, there is considerable uncertainty as to the intended effect of this language on companies granting compensatory stock rights in a reasonable good faith effort to comply with the statute. We recommend that the Regulations, as finalized, confirm that if an interpretation of the statute and Notice 2005-1 would have been a reasonable good faith interpretation if made before the issuance of the Proposed Regulations, the same interpretation will be treated as having been made reasonably and in good faith notwithstanding a contrary provision in the Proposed Regulations, including a provision characterized as a clarification.

Moreover, given the uncertainty faced by many companies pending issuance of final regulations, and the need for continued granting of compensatory stock rights during such period, we also recommend that the Regulations, as finalized, provide extended transition relief permitting stock rights granted prior to the effective date of final regulations to continue to be exempt from the requirements of Section 409A until such rights expire in accordance with reasonable terms for such stock rights.

D. Dividend Rights – Separate Arrangement

1. Summary

The Proposed Regulations include a new rule relating to an optionholder’s right to receive, upon exercise of an option, amounts equivalent to dividends declared and paid on the stock underlying the option. This rule provides support for the requirement that the exercise price of an option must never drop below the fair market value of the underlying stock as of the option’s grant date. However, the rule appears to require not only that accrued dividends not become payable upon exercise of the option, but also that any right to dividend amounts be set forth in a separate written instrument.

2. Recommendation

We recommend that the Regulations, as finalized, provide that a right to dividend equivalents or similar payments associated with shares underlying a stock right need not be set forth in a separate instrument in order to avoid causing the stock right to be subject to Section 409A, as long as the amounts are not payable upon exercise of the stock right.

3. Explanation

The “separate arrangement” provision in the Proposed Regulations does not appear related to the need to ensure that dividend rights do not, in substance, result in a reduction in the exercise price or an increase in the amount payable upon exercise. Proposed Regulations § 1.409A-1(b)(5)(i)(E) provides:

For purposes of this paragraph (b)(5)(i), the right to receive, upon the exercise of a stock right, an amount equal to all or part of the dividends declared and paid on the number of
shares underlying the stock right between the date of grant and the date of exercise of the stock right constitutes an offset to the exercise price of the stock option or an increase in the amount payable under the stock appreciation right (generally causing such stock rights to be subject to Section 409A), unless the right to the dividends declared and paid on the number of shares underlying the stock right is explicitly set forth as a separate arrangement.\textsuperscript{18}

The requirement of a “separate arrangement” may be intended to ensure that dividend equivalents are paid in accordance with the time and form of payment requirements of Section 409A, and not upon exercise of the stock right. However, a provision within a stock right instrument (for example, a stock option agreement) that operates independently of the exercise provisions should serve this purpose as well as a separate written instrument would. Accordingly, the Regulations, as finalized, should clarify that a “separate arrangement” for this purpose does not require a separate written instrument. Moreover, a provision of this type included in an award instrument that does not make payment depend on exercise of the award should not cause the stock right to fail to satisfy any requirement of Section 409A. If the separate provision fails to comply with the time and form of payment requirements, the dividend right could then be treated as a noncompliant deferred compensation right without the stock right itself being treated as nonqualified deferred compensation.

E. Adjustments for Corporate Transactions

1. Summary

The Proposed Regulations provide that the substitution of a new stock right for an outstanding stock right pursuant to a corporate transaction will not be treated as the grant of a new stock right or a change in the form of payment for purposes of Section 409A, provided that the requirements of Treasury Regulation § 1.424-1 would be met if the stock right were a statutory option.\textsuperscript{19} Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(3) also refers to substitutions and assumptions in connection with a “corporate transaction,” although this time without a direct cross-reference to Treasury Regulation § 1.424-1(a).

2. Recommendation

We recommend that the Regulations, as finalized, clarify, by means of a specific cross-reference, that the term “corporate transaction” as used in Proposed Regulations § 1.409A-1(b)(5)(iii)(D)(3) means a “corporate transaction” as that term is used in Treasury Regulation § 1.424-1(a)(3).

3. Explanation

The Proposed Regulations follow Notice 2005-1 in providing that the substitution of a new stock right for an outstanding stock right, or the assumption of an outstanding stock right,

\textsuperscript{18} 70 Fed Reg. 57930, 57960 (Oct. 4, 2005).

pursuant to a corporate transaction will not be treated as a modification resulting in the grant of a new stock right or a change in the form of payment for purposes of Section 409A, if the requirements of Treasury Regulation § 1.424-1 would be met if the stock right were a statutory option. (The only exception deals with the treatment of the ratio of the exercise price to the fair market value of the stock, which is handled differently in Notice 2005-1 and the Proposed Regulations than in the regulations under Section 424, and this exception is not relevant here.)

However, the Proposed Regulations use the term “corporate transaction” without an explicit definition, although in one context the link to Treasury Regulation § 1.424-1 appears implicit.

Clarity on the applicability of Treasury Regulation § 1.424-1 is necessary to avoid confusion and uncertainty. We believe that a clarification treating stock rights as not having been modified merely because they are appropriately adjusted to reflect changes in the service recipient’s equity, of the type specified in the regulations under Section 424, is consistent with the statute’s objective and clarifies the intent of the Proposed Regulations.

F. Application of Ownership Thresholds

1. Summary

The Proposed Regulations provide that the definition of the term “stock of the service recipient” used for purposes of grants of stock rights may be determined, at the election of the service recipient, by modifying the percentage ownership requirements otherwise applicable under the Proposed Regulations for determining the service-recipient group to a 50% ownership level, rather than 80% or 20% where based upon “legitimate business criteria.”

The Regulations, as finalized, should clarify (a) the interaction of the 80% (or 50%) rule with the 20% rule when legitimate business criteria support use of the 20% standard for certain members of a group but may not support it for other members of a group and (b) certain other aspects of these rules.

2. Recommendation

We recommend that the Regulations, as finalized, incorporate several rules to clarify the application of Proposed Regulations § 1.409A-1(b)(5)(iii)(D) permitting use of a threshold of either 50% or 20%, rather than 80%, for determining “stock of the service recipient” with respect to which stock rights may be granted. Specifically, we recommend that the Regulations, as finalized, provide that, in cases in which the service recipient elects to use the 20% threshold, the Regulations, as finalized, do not require the service recipient to demonstrate that there are legitimate business criteria for granting stock rights to any individual who provides service to an entity meeting the 50% ownership threshold. The Regulations, as finalized, should also clarify that the 20% threshold may be elected for a group and applied with respect to any businesses for which there are legitimate business criteria for doing so, even if the service recipient may not have legitimate business reasons for granting stock rights to employees of other entities that meet the 20% ownership threshold. Finally, the Regulations, as finalized, should clarify that an entity included as a service recipient with one group of businesses on the basis of the designation of

either a 50% or a 20% threshold by that group could also be included as a service recipient with another entity, group of entities or multiple groups of entities based on similar designations by those entities.

3. **Explanation**

For purposes of determining the “stock of the service recipient” with respect to which stock rights may be granted, the Proposed Regulations provide that the definition of service recipient may be modified by relaxing the relevant percentage ownership threshold, at the election of the service recipient, to a 50% rather than an 80% ownership test or to 20% where supported by “legitimate business criteria.”\(^{22}\) The Proposed Regulations further require consistency in the use of the 50% or 20% thresholds and provide that “any designation of a different permissible ownership threshold percentage” may not be effective until 12 months after adoption of the change.\(^{23}\) It is not clear from the Proposed Regulations, however, how the 80% or 50% rules interact with the 20% rule in all cases or how the consistency rule applies in all cases.

For example, it is not clear whether a corporate group operating under the 80% standard may continue to use that test for purposes of determining the members of the service recipient group generally, while implementing the 20% test with respect to a particular less-than-50%-owned venture to the extent legitimate business criteria would support the grant of parent company stock rights to employees of that venture. Obviously if such a group consisted of one corporation in which the parent owned at least 20% of the stock and other corporations in which the parent owned at least 80% of the stock, and the group elected the 20% threshold, all members of the group would satisfy the lower ownership threshold. Would it be necessary, however, for the parent in this case to demonstrate that there were legitimate business criteria to grant rights in parent stock to employees of the 80% subsidiaries because the parent had designated that it would use the 20% threshold? We believe that the election of the 20% threshold to accommodate stock grants to one or more entities at that ownership level should not result in added administrative burdens for service recipients that would require them to demonstrate that there are legitimate business criteria for granting stock rights to service providers of entities that would satisfy either the 80% or 50% ownership thresholds, since the Proposed Regulations do not otherwise impose such a requirement for service recipients that use the higher thresholds. The Regulations, as finalized, should clarify that, in a situation in which a service recipient designates use of the 20% threshold, with respect to any entity that would satisfy the 50% threshold, there is either no requirement to demonstrate that there are legitimate business criteria for granting stock rights to service providers of the 50% owned entity, or there are *deemed* to be legitimate business criteria to support the grant of stock rights to such service providers.

Also, using the same facts as in the above example, what implications would the election of the 20% threshold and the consistency requirement have if the group also included, *e.g.*, a joint venture in which the parent had a 25% interest, another unrelated entity had the remaining 75% interest and the parent concluded that there were *not* legitimate business criteria to support granting rights in the parent’s stock to employees of the 25% joint venture? We believe that if


there are legitimate business reasons to grant stock rights to employees of one such joint venture but not another, the consistency requirement should not preclude use of the 20% threshold for the entity for which the legitimate business criteria requirement is satisfied. Thus, the Regulations, as finalized, should further clarify that the consistency rule does not require that the service recipient may elect the 20% threshold only if the service recipient determines that legitimate business criteria provide a basis for the use of the 20% threshold for every entity in which the service recipient has at least a 20% common ownership interest. Instead, use of the 20% threshold should be permitted to the extent legitimate business criteria provide a basis for doing so.

Finally, the Proposed Regulations include no indication of whether an entity can or cannot be considered to be affiliated with more than one service recipient. We presume that the lack of an explicit rule means that a business, affiliated with a particular service recipient as a result of that service recipient’s election of either a 50% or 20% threshold for this purpose, may also be affiliated with one or more other service recipients on the basis of designations by those service recipients of a 50% or 20% threshold (assuming that the legitimate business criteria requirement is satisfied in each case in which the 20% threshold is designated). We believe that there are a number of situations in which service providers of one entity with multiple owners should be entitled to receive stock rights with respect to stock of all, or at least more than one, of the owners. The most common of these situations is one in which two or more businesses form a joint venture and each business transfers employees to the joint venture. To provide the proper business incentives to the employees of such a joint venture, the owners may desire that the employees receive grants of stock rights with respect to stock of each of the owners. Because the Proposed Regulations do not preclude this result (if the relevant ownership threshold is met) and it is consistent with the reasons described in the Preamble for allowing the use of the lower thresholds for grants of stock rights, we believe this result is permissible. Nonetheless, we recommend that the Regulations, as finalized, expressly state that the inclusion of an entity as a member of one service recipient pursuant to an election of a 50% or 20% threshold by that service recipient does not preclude the entity from also being included as a member of another service recipient.