February 27, 2006

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

Re: Valuation of Private Company Stock and Modification of Stock Options and Stock Appreciation Rights under IRC Section 409A Proposed Regulations

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 409A Proposed Regulations concerning Valuation of Private Company Stock and Modification of Stock Options and Stock Appreciation Rights. 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  
    Stephen Tackney, Office of Division Counsel, Associate Chief Counsel TEGE, IRS  
    Bill Bortz, Office of Benefits Tax Counsel, Department of Treasury  
    Daniel Hogans, Attorney Advisor Office of Benefits Tax Counsel, Department of Treasury
COMMENTS ON PROPOSED REGULATIONS UNDER CODE SECTION 409A REGARDING VALUATION OF PRIVATE COMPANY STOCK AND MODIFICATION OF STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

The following comments (“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 Scott Spector. Substantive contributions were made by William D. Jewett, Pamela Baker, and R. Hardin Matthews. The Comments were reviewed by Wayne R. Luepker, Chair of the Subcommittee on Executive Compensation, and Greta E. Cowart and James Raborn, Chair-Elect and Chair respectively, 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 member 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.

Contact:
Wayne R. Luepker
312-701-7197
wluepker@mayerbrownrowe.com

Scott Spector
650-335-7251
sspector@fenwick.com

Date: February 10, 2006
COMMENTS ON PROPOSED REGULATIONS UNDER CODE SECTION 409A REGARDING VALUATION OF PRIVATE COMPANY STOCK AND MODIFICATION OF STOCK OPTIONS AND STOCK APPRECIATION RIGHTS

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 provisions of the Proposed Treasury Regulations under Section 409A regarding the valuation of the illiquid stock of a start-up corporation, and the modification of stock rights under Section 409A.

We commend the Internal Revenue Service (the “Service”) and the U.S. Department of the Treasury (the “Treasury”) for the extensive and well-considered Proposed Regulations addressing many difficult issues.

We appreciate the clarifications that the Proposed Regulations provide with respect to treatment of stock options and stock appreciation rights (“stock rights”) under Section 409A and the recognition of the difficulties inherent in valuing private company stock. We continue, however, to have concerns with respect to the provisions regarding valuation of the illiquid stock of a start-up corporation. Further, although the Proposed Regulations favorably address certain modifications to stock rights which extend the term of a stock right, certain noncompliant extensions made prior to the publication of the Notice 2005-1 are not exempt under Section 409A or would become subject to Section 409A pursuant to the Proposed Regulations, which we believe is unwarranted.

I. EXECUTIVE SUMMARY

Our recommendations are as follows:

A. We recommend that the Regulations, as finalized, provide that the valuation report required to meet the presumption of reasonableness described in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(2)(iii) may be prepared by, or at the direction of, a member of the service recipient’s Board of Directors or by an employee of the service recipient (such as the CEO or CFO), provided that the individual preparing or directing the report has significant knowledge and experience or training in performing valuations and will not be a recipient of a stock right grant based upon the valuation, and the valuation report is reviewed and approved by a majority of the disinterested members of the Board of Directors.

B. We recommend that Section 1.409A-1(b)(5)(iv)(B)(2)(iii) of the Regulations, as finalized, reduce the time period during which an initial public offering of securities (an

1 All references to Section herein shall be references to sections in the Code unless otherwise expressly stated.
2 All references herein to the “Proposed Regulations” shall be to the Proposed Treasury Regulations issued under Section 409A, unless otherwise explicitly stated.
3 2005-2 IRB 274 (January 10, 2005). All references herein to “Notice 2005-1” shall be to this Notice, unless otherwise explicitly stated.
“IPO”) may reasonably be anticipated from 12 months to 6 months and reduce the period during which a change in control may reasonably be anticipated from 12 months to 3 months, unless prior to either such period, the service recipient has taken objective steps in furtherance of the change in control or IPO, such as negotiating a change in control term sheet, or hiring investment bankers or underwriters, in which case the period would commence with the taking of such objective steps. In addition, we recommend that the Regulations, as finalized, provide that if a change in control or IPO does in fact occur within either such period, the occurrence should not eliminate the possibility of using the illiquid start-up safe harbor, but rather create only a rebuttable presumption that the service recipient should have reasonably anticipated the change in control or IPO. Such presumption could be rebutted by the service recipient. In addition, we recommend that the Regulations, as finalized, provide an objective definition of what steps constitute reasonable anticipation of an IPO or change in control.

C. We recommend, with respect to modifications of stock rights that were completed prior to the final publication of Notice 2005-1, that the Regulations, as finalized, provide that such modifications to extend the term of a stock right should not cause the stock right to be subject to Section 409A.

II. COMMENTS

A. Presumption of reasonableness for the valuation of illiquid stock of a start-up corporation – who may prepare the report?

1. Summary

The Proposed Regulations provide a presumption of reasonableness with respect to determining the fair market value of stock of an illiquid start-up corporation. The Proposed Regulations do not explicitly state, however, who may prepare the report required by the valuation method described in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(2)(iii).

2. Recommendation

We recommend that the Regulations, as finalized, provide that the valuation report required to meet the presumption of reasonableness described in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(2)(iii) may be prepared by, or at the direction of, a member of the service recipient’s Board of Directors or by an employee of the service recipient (such as the CEO or CFO), provided that the individual preparing or directing the report has significant knowledge and experience in performing valuations and will not be a recipient of a stock right grant based upon the valuation, and the valuation report is reviewed and approved by a majority of the disinterested members of the Board of Directors.

3. Explanation

We believe that the Service’s intent in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(2)(iii) was to provide start-up companies with the ability to perform valuations that would be presumed to be reasonable without having to incur the expense of hiring an outside
appraiser. However, the Proposed Regulations do not elaborate on who may perform the valuation other than requiring that the individual have the requisite knowledge, training and experience. Neither the statute nor the legislative history requires a valuation to be performed by any certain party.

Many start-up companies have, as members of their Board of Directors or as employees in roles such as CEOs and CFOs, individuals with substantial experience and expertise in investing in and placing a value on a start-up corporation. These individuals provide a valuable resource for their respective companies through their valuation advice and guidance. While the Proposed Regulations do not prohibit these individuals from performing the valuation report required in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(iii), neither do they explicitly authorize it. Without further clarification, many start-up corporations may hesitate to have a company insider such as an executive or a board member prepare the valuation out of concern that such an individual is not permitted to perform the valuation, despite the fact that such individual may be well qualified to do so. In such a case, those companies that would most benefit from this valuation method would hesitate to use it. In fact, a company insider may be more qualified to prepare the valuation, because that person would be more familiar with the company and its industry than an independent outside valuation expert.

While the Service may have understandable concerns that an internally prepared valuation presents a potential for abuse, this risk can be adequately addressed by adding safeguards. Requiring substantiation of the expertise of the person performing the valuation should address the concerns of the Service regarding the qualification of the preparer. In addition, to prevent any abuse, the person performing the valuation should not be a recipient of a stock right grant based upon such valuation, and any valuation should be reviewed and approved by the majority of the members of the Board of Directors not receiving a grant of stock rights (the “disinterested members”). This should address any concern of the Service that the valuation is motivated by personal interest or benefit. While the Service may have concerns that such a valuation provides a potential for abuse by undervaluing the corporation’s stock, this concern should be alleviated by requiring that the parties directing and preparing the valuation not benefit from stock right grants based on the valuation, and by the fact that the Board of Directors in accepting such valuation has a fiduciary duty to the shareholders to act in the best interest of the shareholders and not to further private interests.

Accordingly, we recommend that the Regulations, as finalized, specifically provide that (i) directors and employees of the service recipient may prepare the valuation report, or direct others to prepare such report, provided the individuals preparing the report have the requisite knowledge and experience or training, (ii) the parties directing or preparing the report do not receive any stock right grants based upon the report, and (iii) the valuation report is reviewed and approved by a majority of the disinterested members of the Board of Directors. We further recommend that the Regulations, as finalized, clarify that listing the potential valuation preparers in the Proposed Regulations is not intended as a limitation on who may prepare the report. In order to assist the Service in substantiating the preparer’s qualifications, the report should affirmatively state the basis for the preparer’s qualifications.
B. Presumption of reasonableness on the valuation of illiquid stock of a start-up corporation – IPO and change in control.

1. Summary

The Proposed Regulations provide that the presumption of reasonableness afforded in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(2)(iii) with respect to the stock of an illiquid start-up corporation will not be available if the service recipient may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control or consummate an IPO within the 12 months following the event to which the valuation is applied (for example, the grant of a stock right) (the “Valuation Event”).

We agree that the Proposed Regulations should contain presumptions of reasonableness with respect to valuations, particularly in the case of companies in the early stages of a start up. However, the presumption of reasonableness afforded in Proposed Regulations § 1.409A-1(b)(5)(iv)(B)(2)(iii) will be difficult for many companies to rely upon due to the requirement that a service recipient may not reasonably anticipate, as of the time the valuation is performed, that the service recipient will undergo a change in control event or make an IPO within 12 months of the Valuation Event.

2. Recommendation

We recommend that Section 1.409A-1(b)(5)(iv)(B)(2)(iii) of the Regulations, as finalized, reduce the time period during which an initial public offering of securities may reasonably be anticipated from 12 months to 6 months and reduce the period during which a change in control may reasonably be anticipated from 12 months to 3 months, unless prior to either such period, the service recipient has taken objective steps in furtherance of the change in control or IPO, such as negotiating a change in control term sheet, or hiring investment bankers or underwriters, in which case the period would commence with the taking of such objective steps. In addition, we recommend that the Regulations, as finalized, provide that if a change in control or IPO does in fact occur within either such period, the occurrence should not eliminate the possibility of using the illiquid start-up safe harbor, but rather create only a rebuttable presumption that the service recipient should have reasonably anticipated the change in control or IPO. Such presumption could be rebutted by the service recipient. In addition, we recommend that the Regulations, as finalized, provide an objective definition of what steps constitute reasonable anticipation of an IPO or change in control.

3. Explanation

We believe that the 12-month period contained in the Proposed Regulations was intended to provide a bright-line test that would prevent companies from ignoring information relating to an impending change in control or an initial public offering when performing valuations. However, it is our belief that the 12-month period is too long for the presumption to be useful, because, in the context of early stage private companies, the possibility of a change in control or an IPO is always present. To require start-up companies to have a 12-month horizon for this purpose is unworkable. In particular, with respect to a merger or acquisition, often times the
entire process of beginning negotiations to closing the transaction is completed over a period of just a few months, if no regulatory approvals are required.

We recommend that Regulations, as finalized, reduce the time period provided for the presumption in the Proposed Regulations from 12 months to 6 months for an IPO. The recommended 6-month period is consistent with NASD Rule 2710(d)(1), which considers compensation received by an underwriter within 180 days prior to a public offering to be compensation in connection with the public offering. By making the Section 409A rule consistent with other applicable laws, the corporation’s compliance with applicable laws will be simplified. This also adopts a standard that has been deemed appropriate and adopted for regulation by the NASD and with which corporations must already comply. In most cases, a corporation could reasonably anticipate within 6 months whether it was going to have an IPO, and it would almost always be the period in which hiring of investment bankers or underwriters would have occurred.

Mergers and other transactions, however, often occur more quickly, if no regulatory approval is required; accordingly, we recommend that the Regulations, as finalized, reduce the time period for the presumption in connection with a change in control from 12 months to 3 months. If the corporation takes objective steps in furtherance of the change in control or an IPO, such as hiring investment bankers or underwriters or negotiating a term sheet, the period would commence with the taking of such objective steps. In addition, we recommend that if a change in control or an IPO in fact occurs within such period, the service recipient and service provider will be presumed to have reasonably anticipated such event only if the presumption cannot be rebutted. Facts that could be used to rebut the presumption could include the service recipient’s proof of the date the service recipient first contacted or hired an investment bank or underwriter, the date the service recipient entered into a term sheet for the sale of the corporation, the date the service recipient executed a letter of intent, the service recipient’s rejection of offers by outsiders to acquire the service recipient, and the date on which negotiations commenced regarding a transaction. Rebuttable presumptions of this type are often used in other areas, such as with respect to the determination of reasonable compensation under the Section 280G regulations.

It is our view that a company will not adjust the timing of a change in control transaction or an IPO merely to preserve a low valuation for option grants, but rather these events are driven by corporate forces unrelated to employee compensation. In order for the presumption to provide companies any certainty, it must contain a time-frame that will not penalize companies that, in good faith, perform a valuation and then enter into a transaction a few months later that was in no way contemplated on the date of the valuation.

The Proposed Regulations provide that the presumption of reasonableness with respect to valuation of illiquid stock of a start-up corporation will not be available if the service recipient “reasonably anticipates” that a change in control or an IPO will occur within 12-months. It is not clear under the Proposed Regulations what the term “reasonably anticipate” means. It could mean only that a change in control or an IPO is possible, which could mean that the safe harbor could never be used, because a change in control or an IPO is always possible in any 12-month period. If “reasonably anticipate” means that the company has been approached by a potential buyer or has begun soliciting advice regarding an IPO, then a better dividing line may exist.
While we believe that something more than a mere possibility is required for a corporation to “reasonably anticipate” a change in control or IPO, we also believe that given the draconian tax consequences of violating Section 409A, many corporations will want to apply this standard in a conservative manner. In any event, the reality is that for many start-up companies, if no regulatory approval is required, the process for negotiation of a merger or other transaction or an IPO requires only a few months.

C. Modifications to extend the period of equity awards prior to the publication of the Proposed Regulations.

1. Summary

Proposed Regulations § 1.409A-1(b)(5)(v)(A) provides that modifications to a stock right which extends the exercise period of the stock right is treated as a deferral of compensation and must meet the requirements under Proposed Regulations § 1.409A-1(b)(5).

Prior to the final publication of Notice 2005-1 on January 10, 2005, it was a common practice to amend previously granted stock rights to extend the period during which the stock right could be exercised, particularly in the context of a termination of employment or a change in control of the issuer of the stock right. The Proposed Regulations would cause many of those amended stock rights to become subject to Section 409A despite the fact that, at the time the amendment was entered into, it was not clear that such an amendment would cause the stock right to be subject to Section 409A.

2. Recommendation

We recommend, with respect to modifications of stock rights that were completed prior to the final publication of Notice 2005-1, that the Regulations, as finalized, provide that such modifications to extend the term of a stock right should not cause the stock right to be subject to Section 409A.

3. Explanation

Often in the context of an individual leaving employment with a company or of a change in control of a company, an individual’s stock right will be amended to allow additional time for exercising the stock right. Section 409A was enacted to curtail abuses that were occurring with respect to income deferrals and to prevent companies from entering into new deferred compensation agreements that permitted individuals to manipulate the timing of income recognition. In the interest of fairness, a stock right that was amended prior to the publication of Notice 2005-1 should not cause that stock right to be subject to Section 409A because at the time of the amendment neither the service recipient nor the grantee was aware that such an amendment would cause the stock right to become subject to Section 409A. We appreciate that Proposed Regulations §§ 1.409A-1(b)(5)(v)(A), (B) and (C) provide a limited safe harbor with respect to extending the exercise period of a stock right. However, prior to publication of Notice 2005-1 on January 10, 2005, is the date of Notice 2005-1’s publication in the Internal Revenue Bulletin, which included the changes to Notice 2005-1 that were made available after its initial publication on December 20, 2004.
2005-1, neither the service provider nor the grantee could have known of the potential issue raised in Notice 2005-1 or of the limitations set forth in the Proposed Regulation necessary to avoid Section 409A treatment.

The Proposed Regulations would require an individual who entered into an agreement that extended the exercise period of options prior to the publication of Notice 2005-1 and possibly even before the enactment of Section 409A (if unvested as of December 31, 2004), to comply with Section 409A. This is an overly punitive requirement, particularly when viewed in light of the fact that neither the service recipient nor the optionee knew at the time of the amendment that it would cause a violation of Section 409A. Clearly, the statutory language of Section 409A does not mandate the treatment of an amendment as the grant of a new stock right or as making the stock right subject to Section 409A from the date of grant. Nor does the legislative history compel such a treatment. There is no potential for future abuse in allowing those amendments that were made prior to the publication of Notice 2005-1 to be exempt from the modification rules of Section 409A, because the exemption would only apply to those grants that were amended prior to the publication of Notice 2005-1. Any modifications outside this limited period will be subject to the requirements applicable to modifications issued in the final regulations under Section 409A.