June 7, 2006

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

Re: Modification of Stock Rights under Proposed Treasury Regulations under Section 409A

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 409A Proposed Regulations concerning the Modification of Stock 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
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    Stephen Tackney, Office of Division Counsel, Associate Chief Counsel TEGE, IRS
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COMMENTS CONCERNING MODIFICATION OF STOCK RIGHTS UNDER PROPOSED TREASURY REGULATIONS UNDER SECTION 409A

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.

Principal responsibility for preparing these Comments was exercised by Andrew L. Oringer, Kenneth A. Raskin, Max J. Schwartz and A. Richard Susko. The Comments were reviewed by 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 Priscilla E. Ryan, Council Director-Elect for the Employee Benefits Committee.

Although members of the Section of Taxation who participated in preparing these Comments have clients who will be affected by the federal income tax rules applicable to the subject matter addressed by these Comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 7, 2006
I. EXECUTIVE SUMMARY

The following Comments are submitted in response to the request for comments made by the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") in the Notice of Proposed Rulemaking, published on October 4, 2005, regarding Proposed Treasury Regulations § 1.409A-1 et. seq.1 (the "Proposed Regulations") issued under Section 409A2 of the Internal Revenue Code of 1986, as amended (the "Code"). These comments address the position of the Service in the Proposed Regulations relating to modifications of stock options and stock appreciation rights (collectively, "stock rights"). For the reasons described below, we believe that revising the rules defining modifications of stock rights as recommended would ease the administrative burdens of compliance with those rules, would accommodate widespread and long-standing practices and would not provide opportunities for abuse.

We have the following recommendations:

A. We recommend the final regulations provide in addition to the limited exception now contained in Proposed Regulations § 1.409A-1(b)(5)(v)(C) that any modification that extends a stock right that is otherwise exempt from Section 409A ("an exempt stock right") will not subject the stock right to Section 409A if: (1) the modification does not extend the right to exercise the stock right beyond the maximum term of the stock right established at grant; (2) the intrinsic value (i.e., the excess of the fair market value of the shares over the exercise price) of the stock right at the time of the modification is not increased; and (3) the exercise price is not reduced, except as permitted in connection with a corporate transaction or similar event.

B. We recommend the final regulations provide that any extension of the term of a stock right that occurred prior to the issuance of the final regulations (or, alternatively, occurred prior to the publication of the Proposed Regulations on October 4, 2005) should not cause the stock right to be treated as a nonqualified deferred compensation plan subject to Section 409A, assuming the stock right was treated as exempt prior to the extension. This recommendation supplements our prior transition period comments on extensions of stock rights.3

C. We recommend the final regulations provide that the no-extension-or-modification rule for preserving a stock right’s status as exempt under Section 409A should apply only prospectively so that such a stock right is subject to Section 409A only from and after the date on which it is extended or modified.

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2 All references to “Section” herein shall be references to sections of the Code unless stated otherwise.

3 The Section’s prior comments are available on the ABA’s website at http://www.abanet.org/tax/pubpolicy/2006/060227stockrights409A.pdf.
II. COMMENTS

A. Extensions Generally

1. Background.

I.R.S. Notice 2005-1, 2005-1 C.B. 274 (“Notice 2005-1”) and the Proposed Regulations provide that the grant of a stock right is not subject to Section 409A if the stock right meets certain requirements. Proposed Regulations § 1.409A-1(b)(5)(v) generally provides that if a stock right is amended after grant to extend or renew the stock right, then the stock right is treated as having had an additional deferral feature from the date of grant. Proposed Regulations § 1.409A-1(b)(5)(v)(C) provides that an extension of a stock right refers to the granting to the holder of an additional period of time beyond the time originally prescribed in the stock right agreement. Proposed Regulations § 1.409A-1(b)(5)(v)(C) also provides a limited exception to this rule in the event the stock right is extended to a date no later than the later of the 15th day of the third month following the date at which, or December 31st of the calendar year in which, the stock right would otherwise have expired if the stock right had not been extended, based on the terms of the stock right at the original grant date.

2. Recommendation.

We recommend the final regulations provide in addition to the limited exception now contained in Proposed Regulations § 1.409A-1(b)(5)(v)(C) that any extension of a stock right that is otherwise exempt from Section 409A (“an exempt stock right”), will not subject the stock right to Section 409A if:

(1) the modification does not extend the right to exercise the stock right beyond the maximum term of the stock right established at grant;4

(2) the intrinsic value (i.e., the excess of the fair market value of the shares over the exercise price) of the stock right at the time of the modification is not increased; and

(3) the exercise price is not reduced, except as permitted in connection with a corporate transaction or similar event.

3. Explanation.

We believe that the final regulations should provide that the status of a stock right as exempt from Section 409A should not be affected by any post-grant extension of a stock right so long as the requirements listed above, which are consistent with the principles of Section 409A, are satisfied. There is no evidence in the Conference Report (H.R. Rep. No. 108-755, 108th Cong., 2d Sess. (2004), and hereinafter “Conference Report”) that Congress considered Section

4 We note that the safe harbor for stock rights in the Proposed Regulations does not limit the maximum term of the stock right and analytically we do not see any reason that an arbitrary period less than the maximum term should limit the extension. We note that occasionally we have encountered stock rights that are even extended beyond their initial maximum terms, for example, in the case of the death of the service provider near the end of the term or other exigencies, such as the securities laws, that make exercise within the term difficult or illegal.
409A as a measure to restrict compensatory stock options or stock appreciation rights (“SARs”) per se or to prohibit service recipients from making reasonable and customary modifications to outstanding stock rights. To the contrary, the Conference Report states that a stock option taxable under Section 83, with an exercise price at least equal to the fair market value of the underlying stock on the grant date and without any deferral feature, other than the right to exercise the option in the future, is not intended to be subject to Section 409A. There is nothing in the Conference Report that would compel Treasury or the Service to subject an outstanding option the term of which is extended after grant to Section 409A if the stock option remains taxable under Section 83.

In our experience, stock rights invariably have a maximum term (often limited to 10 years by the terms of a shareholder-approved plan) that is typically shortened in the original agreement upon the occurrence of certain events, such as termination of employment, the holder’s death or disability or a change in control of the service recipient. Executive employment agreements, severance agreements and the terms of stock right award agreements frequently provide for exceptions to these forfeiture and expiration provisions, specifically in connection with the termination of the holder’s employment without cause or on account of retirement. This approach is consistent with plan provisions that provide broad latitude to the service recipient to design awards within specified parameters (typically precluding “repricing” and extension of rights beyond the maximum term specified in the plan) and to alter outstanding awards within those same parameters.

Under the Proposed Regulations, any amendment of a stock right to extend the exercise period would automatically cause the stock right to be subject to Section 409A retroactively from the date of grant. In contrast, the Proposed Regulations would permit the exercise period of a stock right to be shortened at any time without subjecting the stock right to Section 409A. It is difficult, if not impossible, to anticipate all those circumstances in which extensions of the stock right would be appropriate, and there is no reason to require a service recipient to anticipate the cases in which it would, so long as the extension is not beyond the maximum term of the stock right determined as of the date of grant. Alternatively, service recipients will need to consider achieving the desired flexibility by setting stock rights with a maximum term and reserving the right to exercise negative discretion to scale the stock right back in the case of certain terminations of employment or corporate transactions where circumstances dictate that the stock right terminate (for example, because the company will become privately owned). We see no useful purpose served under Section 409A or otherwise by compelling this change in the design of stock rights.

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5 Conference Report at 735.

6 See Prop. Reg. § 1.409A-1(b)(5)(v)(B) (“In contrast, a change in the terms of the stock right shortening the period during which the stock right is exercisable is not a modification”).

7 See footnote 8. This interpretation of the Proposed Regulations to permit shortening the stock right is consistent with the rules governing incentive stock options and the right to exercise negative discretion under a Section 162(m) performance-based plan.
We believe it is common practice to extend the period in which the stock right may be exercised. For example, the period during which a stock right can be exercised may be extended to allow exercise following termination of the service provider’s employment to provide him or her with the value inherent in the stock right that he or she had a reasonable expectation to receive. These “extensions” also typically occur as part of a corporate restructuring or downsizing. In other cases, the expiration of the exempt stock right may be tolled while exercise of the stock right, or sale or disposition of the underlying service recipient stock immediately following exercise, would violate or subject the service recipient or the service provider to liability or penalty under applicable securities laws or would violate a trading program or policy maintained by the service recipient to facilitate compliance with applicable securities laws. The tolling period extension for periods during which the stock right may not be exercised is intended to encompass situations in which (i) a black-out period, because of the existence of inside information, would prevent the exercise of a stock right or the purchase or resale of shares, (ii) the service recipient is precluded from using a Form S-8 due to an accounting restatement, or (iii) internal trading policies (such as window periods) during which exercise and resale cannot occur preclude a service provider from exercise and resale of a share (such as in a cashless exercise). In some of these situations, there may not be a law that expressly precludes exercise, but amounts gained may be subject to disgorgement or there might be a corporate compliance policy that precludes exercise. It is reasonable to expect the above-listed situations would not be used as a means to manipulate income recognition and all of the above situations are due to the requirements of other laws or restrictions on the service provider. Thus, extensions for such situations do not present any potential for abuse.

We believe that any extension to exercise an exempt stock right that does not extend beyond the right’s original maximum term should not result in subjecting the stock right to Section 409A and possible prohibited deferral of income. Such an extension does not defer the inclusion of compensation in the holder’s gross income beyond the maximum term of the stock right. The right to exercise a stock right in the future is a “deferral feature,” which both the Conference Report and Notice 2005-1 recognize does not cause the stock right to provide for a deferral of compensation subject to Section 409A. We do not believe that an extension to the time otherwise already conferred by the service recipient as the applicable term provides an opportunity for abuse. The final regulations should limit the restrictions on modifications of stock rights to only those narrowly focused on preventing the use of stock rights as vehicles intended to provide disguised deferred compensation in contravention of Section 409A.

Furthermore, with respect to extensions that occur in connection with some terminations of employment, particularly in the case of a reduction in force, spin-off, sale of a subsidiary or other similar termination the service providers typically do not have control over the event and the likelihood of abuse is limited. Similarly, in corporate transactions, the service provider often has no discretion or control over an extension of the exercise period; it is often a term of the transaction negotiated between the opposing party and the service recipient, or provided by the

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8 Conference Report at 735.

9 Q&A-4(d)(ii).
service recipient in an attempt to honor the reasonable expectations of the service providers who may otherwise be adversely affected by the transaction.

B. Prior Extensions

1. Background

Many stock rights were granted, extended or modified before the passage of Section 409A that may not have been vested as of December 31, 2004, and thus were not eligible for grandfathering under the Proposed Regulations. The treatment of such stock rights and any related modification or extension is not clear under the statute. Other stock rights were extended after the passage of Section 409A but before issuance of the Proposed Regulations where the effect of extension was first explicitly addressed.

2. Recommendation

We recommend the final regulations provide that any extension of the term of a stock right that occurred prior to the issuance of the final regulations (or, alternatively, occurred prior to the publication of the Proposed Regulations on October 4, 2005) should not cause the stock right to be treated as a nonqualified deferred compensation plan subject to Section 409A, assuming the stock right was treated as exempt prior to the extension. This recommendation supplements our prior transition period comments on extensions of stock rights.

3. Explanation

Many service recipients who granted or extended stock rights before the passage of Section 409A or before the Proposed Regulations were issued may cause the grantees to be penalized for not having the foresight either to predict the passage of Section 409A or to predict how the Proposed Regulations would treat these issues. The Proposed Regulations do not address how stock rights that were granted or extended prior to the issuance of the Proposed Regulations should be handled. Some of these stock rights will not be eligible for grandfathering under the Proposed Regulations. Businesses needed to continue to operate and provide recruitment and retention incentives to employees during the period after Section 409A was passed and prior to the issuance of the Proposed Regulations. While the Proposed Regulations answered many questions, they did not answer all questions regarding extensions and grants of stock rights, and companies have continued to operate in good faith compliance while waiting for final regulations.

Notice 2005-1 did not provide that the extension of the original term of an otherwise exempt stock right would subject the stock right to the requirements of Section 409A. We

10 Section 885(d) of the American Jobs Creation Act of 2004; Notice 2005-1, at 275 and Q&A-16.

11 The Section’s prior comments are available on the ABA’s website at http://www.abanet.org/tax/pubpolicy/2006/060227stockrights409A.pdf.
believe many service recipients, relying on the guidance provided in Notice 2005-1, may have extended the exercise period of previously exempt stock rights (i.e., those stock rights with an exercise price at or above the fair market value of the underlying stock on the date of grant which otherwise satisfy the applicable requirements) without realizing that such an amendment would subject the stock right to the requirements of Section 409A. Similarly, many service recipients may have extended the terms of outstanding stock rights prior to the enactment of Section 409A. It is not clear whether such a change would result in the stock right being subject to Section 409A. Thus, even if the relief requested in part A above is not granted, we believe that any extension of the term of a stock right that occurred prior to the issuance of the final regulations (or, alternatively, the publication of the Proposed Regulations on October 4, 2005) should not be treated as a deferral of compensation in order not to penalize taxpayers who have attempted to comply in good faith in this interim period, provided it was exempt prior to the extension. Any retroactive application of a no-extension rule would interfere with binding contractual rights that were entered into in good faith.

C. Prospective Application

1. Background

Prior to the issuance of the Proposed Regulations on October 4, 2005, we understand some taxpayers were not aware that extension or modification of stock rights would have the severe consequences of converting a granted stock right from being exempt from Section 409A to being subject to Section 409A.

2. Recommendation

We recommend the final regulations provide that the no-extension-or-modification rule for preserving a stock right’s status as exempt under Section 409A should apply only prospectively so that such a stock right is subject to Section 409A only from and after the date on which it is extended or modified.

3. Explanation

Any extension of the time to exercise a stock right or a modification of a stock right should only affect the stock right from the date of the change and not retroactively to the date of grant. If a stock right as originally granted was exempt from the application of Section 409A, a subsequent modification does not change the nature of the stock right in the prior tax years. The U.S. taxation system is based upon tax years and the income, expenses, and rights that existed in each such tax year. Treating an extension or modification in a subsequent tax year as changing the nature of the rights that existed in prior years is inconsistent with the fact that the prior tax years and the rights in those years have been determined, and may in fact be closed due to the application of a statute of limitations. Furthermore, in the tax years prior to the modification, the stock right was not a nonqualified deferred compensation plan subject to Section 409A. The retroactive rule presently in the Proposed Regulations is not justified by the statute or the Conference Report. If the grant had no element of deferred compensation when granted, the fact there is an extension or modification that was unforeseen at the time of grant should not cause
the stock right to be treated as no longer exempt for years in which it met the exemption’s requirements.