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VIA ELECTRONIC AND HAND DELIVERY

Eric Solomon
Acting Assistant Secretary (Tax Policy)
Deputy Assistant Secretary for Regulatory Affairs
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Nancy J. Marks
Associate Chief Counsel (TEGE)
Internal Revenue Service
CC: TEGE: EOEG
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Code Section 409A – Permanent Exceptions for Equity Appreciation Rights

Dear Eric and Nan:

I am writing on behalf of the member companies of the American Benefits Council (the "Council") and the Council's special task force on deferred compensation to provide comments on Internal Revenue Code section 409A and on Notice 2005-1, 2005-2 I.R.B. 274. This comment suggests that published guidance adopt a broader permanent exception from section 409A for equity appreciation rights, including equity appreciation rights that are settled in cash and equity appreciation rights that are issued by employers that are not publicly-traded companies. This comment also suggests safe harbors for valuation of equity and addresses certain other issues related to equity appreciation rights.

We appreciate the guidance on equity compensation that has been issued so far, including the exception from section 409A for stock options issued at fair market value, transfers of property, such as restricted stock, that are taxable under section 83, and transition relief for existing equity programs. We are concerned, however,

that in the post-transition period, the exceptions for equity appreciation rights provided so far will disadvantage private companies and preclude otherwise reasonable practices of both public and private companies, such as cash settlements in lieu of stock transfers, that should not lead to different results under Code section 409A. While we understand that Treasury and the Service have concerns about issues regarding valuation of private company equity, we suggest that these concerns can be addressed through guidance on reasonable valuation. More importantly, these concerns are not a sufficient basis to support a rule that significantly affects the ability of private employers to compensate their employees with equity incentive arrangements.

Part I set forth below discusses our recommendations for a permanent, single exception from section 409A for equity rights, including both options and appreciation rights. Part II discusses specific issues related to the valuation of equity rights for employers and service recipients that are not publicly-traded companies and suggests safe harbors for determining the fair market value of equity that underlies an option or appreciation right. Part III describes additional issues related to equity awards and section 409A that should be addressed in published guidance.

Part I Exceptions for Equity, Including Options and Appreciation Rights

Overview. Notice 2005-1 provides that certain stock options and stock appreciation rights are not considered plans that provide for deferral of compensation for purposes of section 409A. Most significantly, the exceptions preclude appreciation rights that are settled in cash and differentiate between appreciation rights that are issued by public rather than private companies, with the practical effect that, in the future, private companies will have limited ability to use equity appreciation as a form of incentive compensation relative to public companies. We suggest that this distinction disadvantages private companies in a way that is not consistent with general tax policy regarding compensation and is not required by section 409A.

Recommendations. Our specific recommendation is that the guidance provide for a uniform exception for grants of equity appreciation rights, including options, issued on equity of the service recipient that satisfy certain requirements. (We refer to such as options and equity appreciation rights generically as "equity appreciation rights" throughout this letter.) All equity appreciation rights would be carved out of section 409A, provided that the following conditions are met:

(1) The right either (i) has an exercise price that cannot be less than the fair market value of the related equity at the date of grant or (ii) is issued under an employee stock purchase plan (as defined in section 423).
(2) The amount received on settlement, regardless of whether the amount is settled in cash or property, is determined by reference to the appreciation in

> the value of the related equity over the exercise price or the fair value of the equity appreciation right.[1]
> (3) Any put or call right associated with equity awarded under such a right provides for purchase at fair market value of the equity.

For purposes of this exception, the service recipient would be the direct service recipient, plus any entity related in a parent-subsidiary chain based on ownership of 50% of the stock or under common control.

This exception would apply to options on corporate stock or partnership interests, and to SARs issued on such stock or partnership interests. Under this exception, SARs could be granted by a public or private company and could be settled in equity or cash.

Background. The legislative history to section 409A reflects Congressional intent that the definition of nonqualified deferred compensation plan not include certain types of equity compensation, including stock options and stock appreciation rights. Specifically, with respect to stock options, the Conference Report states:

> For purposes of the provision, it is not intended that the term "nonqualified deferred compensation plan" include an arrangement taxable under section 83 providing for the grant of 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 provision is not intended to change the tax treatment of incentive stock options meeting the requirements of 422 or options granted under an employee stock purchase plan meeting the requirements of section 423.

The discussion of SARs in the legislative history is not nearly so detailed, providing simply that "The Secretary may also address in regulations issues relating to stock appreciation rights." Section 409A grants Treasury and the IRS broad regulatory authority "to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

Consistent with this history the Notice provides different exceptions for stock options and appreciation rights. We suggest that this complexity is unnecessary and

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[1] An equity appreciation right's "fair value" is calculated using a valuation model such as a modified Black-Scholes or a binomial method. Both options and SARs provide option economics and therefore both types of grants have a "fair value" as well as an intrinsic value (i.e. appreciation over the exercise price).

that the exceptions can instead be combined into a single exception for equity appreciation rights based upon the principles articulated in the legislative history.

Current stock option exceptions in Notice 2005-1. The current exception for nonqualified stock options provides that a compensatory stock option does not provide for deferral of compensation (1) if it is issued on stock of the service recipient, (2) has an exercise price that is never less than the fair market value of the stock on the date the option is granted, (3) the tax treatment of the option is governed by section 83, and (4) the option does not include any feature for the deferral of compensation beyond exercise or disposition of the option. The nonqualified stock option exception does not distinguish between public and private companies. The second exception for stock options applies to options that fit the definition of incentive stock option under section 422 or employee stock purchase plan options under section 423, and also applies to both public and private companies.

Current stock appreciation rights exception and transition rule in Notice 2005-1. The first exception is similar to the exception for nonqualified stock options, except that it is limited to SARs granted with respect to stock of the service recipient that is traded on an established securities market. In addition, the SAR must provide only for appreciation over the fair market value of the stock at the date of grant, must settle in stock, and cannot include a feature for the deferral of compensation beyond settlement of the SAR. The Notice cautions that an agreement or arrangement under which the employer will repurchase the stock issued in settlement of the SAR may provide for the deferral of compensation. We understand from informal comments by the Service and Treasury that the prohibition on sales and repurchases between the service provider and service recipient applies even if the transaction is based upon the fair market value of the SAR.[2] The requirement that the SAR settle only in stock also differentiates it from the option exception, which requires only that the exercise or disposition of the option be governed by section 83, a requirement that is satisfied if an option is disposed of for cash.

The second SAR exception provides only transition relief. Under this transition relief exception, SARs may settle in cash or stock and be issued without regard to whether the stock is publicly traded, but only with respect to grants pursuant to a program in effect on or before October 3, 2004. The SAR also must provide only for appreciation over the fair market value of the stock at the date of grant and can not include any feature for the deferral of compensation beyond settlement of the SAR.

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[2] We note, however, that as the Notice provides that such an arrangement may give rise to deferred compensation, it is not clear that a transaction at fair market value, which would not have a compensatory element, is inconsistent with the provision of the Notice.

A single, permanent exception under section 409A would avoid unnecessary distinctions between different types of services recipients and employers. We suggest that the differences in the exceptions provided in Notice 2005-1 are not necessary in order to implement section 409A. The current rules in Notice 2005-1 draw distinctions based upon the identity of the employer rather than the substance of the compensation arrangement, creating differences in the way that otherwise similar companies can compensate their employees.

Under the option exception, it is permissible for the service recipient to provide for cash-out of the option and further to base the payment on either the difference between the exercise price and the fair market value of the option property or the fair value of the option. In each of these situations, the tax treatment of the transaction will be governed by section 83, the requirement for options. In contrast, under the existing SAR exception, the SAR can provide only for appreciation in the related equity and must settle in stock. Therefore, the issuer of SARs does not have the same flexibility to cash out SARs or provide an amount equal to the value of the SAR itself, rather than just appreciation. We see no policy reason to make such a distinction regardless of whether the issuer is a public or privately-held company, but this distinction between cash and stock settled SARs creates particular difficulties for private companies that cannot readily transfer stock outside a current ownership group.

Moreover, the exceptions for SARs in Notice 2005-1 do not include any ongoing provision that will allow private companies to issue SARs after a transition period or under a program that was not already in place on October 3, 2004. An employer that had a program in place on October 3, 2004, can continue to grant SARs, but only so long as that plan provides for such grants and, implicitly, until the transition period under Notice 2005-1 is limited by further guidance. We understand that Treasury and the Service are concerned about issues related to valuation of private companies. As discussed below in detail in Part II of this comment, our members are equally interested in further guidance on permissible valuation methods under section 409A. We recognize that there are significant issues about reasonable valuation and the possibilities of manipulation to create the equivalent of a cash bonus plan, but in our view these concerns relate solely to the uncertainties associated with determining the fair market value of a private company. Those uncertainties associated with valuing private companies does not justify eliminating SARs as a compensation method for private companies.

One potential distinction that has been raised is that stock options are taxed under section 83 while SARs are taxed under section 451. We believe that this is not a meaningful difference for purposes of section 409A, however, because, in economic terms, the two grants are equivalent: each rewards the holder with appreciation in equity value over the value at the date of grant. In general, stock options allow

employees to purchase the full amount of option shares, while SARs provide only for delivery of an amount equal to post-grant appreciation (the spread). On the other hand, stock options can be designed to allow cashless exercise or exercise through tender of previously owned shares so that the option effectively delivers shares in value equal to the spread. An "option" that provides for net settlement in stock is indistinguishable from a stock appreciation right. Setting section 409A aside, in most cases, whether an appreciation right is analyzed under section 83 or 451 is not significant.[3] For the service provider in particular, the amount and timing of income should be the same.

Because stock options and SARs are economically equivalent, companies choose to offer one form over the other for reasons that have little to do with tax, but instead relate to securities laws, shareholder agreements, and concern about imposition of additional costs on employees. Under the securities laws, private companies are limited in the amount of stock, and options on stock, that they can issue to employees without being required to register. For most private companies, this means that stock cannot be transferred to more than 500 shareholders. Even if securities rules are not an issue, private companies, for legitimate business reasons, often are not willing to have former employees continue to hold shares, and so arrange either to pay cash on exercise of an equity appreciation right or to retain the right to repurchase, based on the applicable measure of fair market value, any shares that are issued. Issuance of private company stock rather than the same value in cash can also impose burdens on employees if the stock is not easily liquidated. Private companies often provide for delivery of cash instead of stock as a way of helping employees achieve liquidity to pay taxes or without incurring brokerage fees.

Even companies in a controlled group that includes a company with publicly traded stock may want to provide compensation based on appreciation in employer equity other than the publicly traded stock. For example, a wholly-owned subsidiary of a publicly-traded parent may want to provide compensation based on appreciation of subsidiary value, not the value of the parent. The subsidiary shares are not traded, and the parent may not want to allow the subsidiary to deliver the shares it holds to employees. There does not seem to be a reason, however, to limit the ability of that subsidiary to deliver compensation to its employees based on the performance of their direct employer.

We also suggest that an equity appreciation rights exception be broad enough to apply to rights granted on any class of equity, as an employer might want to issue equity appreciation rights on classes of stock other than common stock, again even in situations in which the common stock is traded. For example, non-employee shareholders may hold both common and preferred stock. In order to provide a

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[3] One exception is the timing of the deduction for non-fiscal year taxpayers.

comparable ownership opportunity for employees, the employer would need to grant options on both classes of stock.[4]

In short, the reasons why any company might choose to use equity appreciation rights other than options or provide for distribution in cash instead of stock have little to do with the amount of compensation to be paid or the tax consequences of the income received. The ability to compensate employees with equity appreciation rights, however, is one that should be available to any employer, without regard to these other issues. Historically, options and SARs have been treated comparably, an approach that should continue under section 409A.

Another technical, but nonetheless problematic, result under Notice 2005-1 arises from the definition of a service recipient. The two exceptions for stock options allow corporations to issues options to employees in circumstances when a partnership could not issue a similar option. This disparity results from the adoption of an 80%-based control test for parent-subsidiary corporations as the general definition of service recipient under Notice 2005-1. As a further exception, however, corporations may issue statutory options, such as incentive stock options and employee stock purchase plan options, which incorporate a 50% control test for parent-subsidiary corporations.

The uniform rule that we propose would avoid these disparities. It would treat compensation based upon equity the same for section 409A purposes regardless of the structure of the service recipient or the employer. It would not impose undue burdens on privately-held businesses in favor of publicly-traded companies, and it would be consistent with the legislative history's description of the equity grants that should not be subject to section 409A requirements without creating undue complexity or traps for the unwary.

<u>Part II Reasonable valuation methods</u>

<u>Overview</u>. A separate but fundamentally important issue relates to the requirement that any option or SAR be issued with an exercise price that cannot be less than the fair market value of the underlying stock as of the date of grant. In the exception for stock options, Notice 2005-1 provides that any reasonable valuation method can be used for this purpose, including methods set forth in § 20.2031-2 of

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[4] We understand that there may be some concern that an employer might recapitalize to create a special "deferred compensation" class of stock. In this regard, we note that any equity appreciation right must be granted on an interest that is in fact equity, rather than debt. As further protection, we suggest it would be sufficient to provide that the exception for equity appreciation rights not cover any right issued on a class of equity created for the purpose of avoiding the requirements of section 409A. Given the adverse consequences of failing to comply with this exception, such an anti-abuse provision is sufficient to discourage the development of special classes of "deferred compensation" stock.

the Estate Tax Regulations. Whether a method is reasonable is determined on the basis of facts and circumstances, taking into account such factors as independent valuations or recent sales or purchases of stock from third parties. The same standard for reasonable valuation should apply equally to all equity appreciation rights.

Recommendation. As discussed further below, we recommend that Treasury and the Service issue guidance that includes safe harbors, as set forth below, and explicitly provides that a valuation that is reasonable at the time does not fail to be reasonable if later determined to be incorrect.

Background. We understand that Treasury and the Service are concerned about different valuation approaches and the potential for the manipulation of valuation, and that this concern affected the scope of the exception with respect to private companies under Notice 2005-1.[5] We believe that concerns about valuation should not drive the scope of the equity exception under section 409A, however, when IRS and Treasury can provide guidance on valuation that would shape behavior. Many employers are interested in receiving additional guidance on what constitutes a reasonable valuation method because of the importance of complying with this requirement under section 409A. Equity compensation is an important part of the compensation package for many employers, with equity appreciation rights often granted under a broad-based plan. Equity appreciation rights with an exercise price equal to fair market value at the date of grant is already a common approach, without regard to section 409A. Indeed, employers are often interested in ensuring that rights granted to employees do not have any built-in value, and have adopted plans with this requirement and communicated this design to other shareholders. Finally, it is employees that bear the adverse tax consequences of failure to comply with section 409A; employers are interested in a grant that provides incentives, without exposing employees to the additional tax imposed by section 409A.

Stock Traded on an Established Securities Market. To the extent that a stock is regularly traded on an established securities market, the market price should be the fair market value of the stock. Published guidance should provide a limited safe harbor, however, for certain administrative practices and rules of convenience that assist employers in administering broad-based arrangements but should not affect compliance with a section 409A exception. For example, we suggest that it should be permissible to set the exercise price based on market prices on the date prior to the date of grant, provided that the method for setting the price is addressed in the plan

[5] Notice 2005-1, Sec. I.B. ("The Treasury Department and the Service are concerned that a general exception for stock appreciation rights may be exploited as a method to avoid application of § 409A, particularly in regard to valuation of the underlying stock where the value is not established by and in an established securities market. In many respects, stock appreciation rights are similar to other forms of nonqualified deferred compensation, particularly where the recipient of a stock appreciation right may receive cash.")

(or grant), and is based on trading prices reasonably contemporaneous with, the grant. Thus, for example, an option grant should not fail to be considered "at the money" simply because the exercise price is set at the average of the high and low prices on the date before the grant. Allowing the employer the ability to provide that grants will be issued with an exercise price determined using pricing information that is not limited to the actual date of grant will aid in administration without providing opportunity for manipulation or imbedding deferred compensation. Indeed, at the time the plan is adopted or the grant approved, the employer cannot predict whether data from the day before the date of grant or on the actual date of grant will prove more favorable.

For stock that is more thinly traded, the rules of § 20.2031-2 of the Estate Tax Regulations provide sufficient guidance, except that to the extent that there is no trading activity on the day of or the day before grant, guidance should make it clear that there is no requirement to take into account trading activity after the date of grant.

Finally, for this purpose, we suggest that the regulations should confirm that "an established securities market" is not limited to a domestic securities market. For example, the definition of this term in Treas. Reg. § 1.897-1(m) (1) includes not only domestic securities exchanges but also any "foreign national securities exchange which is officially recognized, sanctioned or supervised by governmental authority."

Private Company Stock. For private company stock, the lack of an established securities market does not mean that the stock cannot be fairly valued. In most general terms, "fair market value" is the price at which property would change hands between a willing buyer and a willing seller, assuming neither is under compulsion to complete the transaction and both have reasonable knowledge of the relevant facts. It is because this is also a good working description of trading activity on an established securities market that prices on such a market are treated as fair market value without further inquiry.

An established market does not provide the only way, however, to determine what a willing buyer would pay a willing seller. For some private companies, there is sufficient investment and other activity with respect to shares that these transactions can provide the basis for determining fair market value. Some private companies, through shareholders agreements or otherwise, essentially define the market for the stock by regulating the price at which shares can be traded by any shareholder. In other cases, review of the relevant facts about a company can provide a basis for determining fair market value. In short, while determination of fair market value may not be as readily apparent for private companies as it is in the context of a publicly traded company, there are ways to determine the fair market

value of a private company with sufficient confidence to conclude that an equity appreciation right has been granted "at the money."

When there are no available transactions, section 20.2031-2 of the Estate Tax Regulations provides that the fair market value determined on the basis of "the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors." With respect to other relevant factors, the regulation provides the following:

> the good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.

Estate Tax Reg. § 20.2031-2(f).

These factors are similar to those identified in other contexts involving valuation. For example, <u>Standard 9: Business Appraisal, Development</u>, published by the Appraisal Foundation,[6] also addresses the information that should be gathered and analyzed as part of a valuation that overlaps with the list provided in Estate Tax Reg. § 20.2031-2(f). In part, the standard provides the following:

> In developing a business or intangible asset appraisal, an appraiser must collect and analyze all information pertinent to the appraisal problem, given the scope of work identified . . . .
>
> (a) An appraiser must develop value opinion(s) and conclusion(s) by use of one or more approaches that apply to the specific appraisal assignment; and
>
> (b) include in the analyses, when relevant, data regarding:
>
> (i) the nature and history of the business;

[6] The Appraisal Foundation is a not-for-profit educational organization founded in 1987. The Foundation publishes the Uniform Standards of Professional Appraisal Practice (USPAP); (www.appraisalfoundation.org).

(ii) financial and economic conditions affecting the business enterprise, its industry, and the general economy;

(iii) past results, current operations, and future prospects of the business enterprise;

(iv) past sales of capital stock or other ownership interests in the business enterprise being appraised;

(v) sales of similar businesses or capital stock of publicly held similar businesses;

(vi) prices, terms, and conditions affecting past sales of similar business equity; and

(vii) economic benefit of intangible assets.

Standard 9-4 (annotations omitted).

Based on these factors, the general rule for section 409A should be that the fair market value should be determined based on relevant information regarding the security to be valued, including, but not limited to, information such as that identified in Estate Tax Reg. § 20.2031-2(f). Moreover, the guidance should be clear that a valuation does not fail to be reasonable solely because the determination was made by the Board of Directors, a committee thereof, or a comparable person or committee with authority to make such determinations for purposes of compensatory grants.

In our view, it is critical, however, that the guidance provide safe harbors. As discussed above, equity appreciation rights are a significant form of compensation for both private and public employers. Employers are interested in understanding what is expected regarding valuation so that they can issue rights to employees without concern that the employees are exposed to income acceleration and additional tax under section 409A.

As a result, we suggest that safe harbors be developed to apply in situations in which the independent information provides sufficient indicia that the fair market value can be established. We suggest that the following safe harbors be included in guidance:

A. *An independent third party valuation*. Such a valuation could be relied on for one year after the date as of which it is effective, unless there are significant

business changes which would render the valuation inaccurate.[7] This approach is similar to that in effect for ESOPs. Given that there are different appraisal methodologies, once a methodology is established, it would need to be applied consistently unless the independent appraiser determines that a different method will provide a more accurate valuation.

B. *Valuation based on third-party activity, such as a business transaction, equity investment or issuance of debt by any party other than a service provider*. This information could be relied on until subsequent third-party activity, but in no event longer than one year.

C. *Nonlapse formula price*. To the extent that all shareholders of the same class of shares are bound by a formula price through the terms of the stock or a shareholder agreement, this formula price is deemed to be fair market value.

D. *A formula price that is based on multiples of earnings*. The formula should be treated as fair market value, provided that "earnings" is defined, and the employer can demonstrate that the multiple used is consistent with valuation methods generally applied to the industry. The same formula must also be used on exercise of the award, unless the related stock is traded on an established securities market at the time of exercise, in which case the market price can be used.

E. *A formula price based on book value*. The formula should be treated as the fair market value if the employer can demonstrate that book value is an acceptable proxy for fair market value in the industry and the same formula is used on exercise of the award, unless the related stock is traded on an established securities market at the time of exercise, in which case the market price can be used.

The last three safe harbors are based on the treatment of nonlapse restrictions for purposes of section 83, as provided in regulations. See Treas. Reg. § 1.83-5(a). Under section 83, a nonlapse restriction is deemed to be fair market value because, by its terms, the restriction will never lapse and thus defines the amount that the employee will receive. The nonlapse formula price safe harbor falls squarely within the section 83 rule because all shareholders are subject to the formula price. The multiples of earnings and book value safe harbors are more narrow, in that each adds a further requirement that the employer provide information that establishes that an earnings multiple or the use of book value is an accepted proxy for fair market value in the employer's industry.

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[7] An alternative approach would be to allow reliance on an independent third party valuation for the period six months before and six months after the valuation is performed.

Allowing the use of formula prices is in the employer's interest, because it allows certainty in setting the exercise price and in calculating the amount payable under the award. Moreover, we suggest that the use of a formula is actually relatively insulated against manipulation, because, as proposed, the same formula is also required to be used at exercise, unless the security becomes traded on an established securities market. To the extent that there is a switch in valuation methods when the stock becomes traded, we suggest that there is no real risk of manipulation, both because the formulas allowed are intended to operate as proxies for fair market value and because the ability to begin trading a security on an established market is not something that is easily controlled for the benefit of recipients of compensatory equity appreciation grants.

Reasonable but Wrong. Finally, with respect both to public and private equity valuations, we suggest that the standard adopted explicitly provide that a valuation is reasonable even if, in hindsight, the valuation proves to be wrong. We believe that this "reasonable but wrong" element is inherent in the concept of a reasonable valuation method. Explicitly stating this provision, however, will provide comfort both to employers and employees who are granted equity appreciation rights that subsequent events or review with the benefit of hindsight will not overturn a valuation that was reasonable at the time the equity appreciation right was granted.

Part III Additional Issues Regarding Equity Appreciation Rights

Modification of Equity Appreciation Rights. We recommend that guidance provide further detail regarding what changes constitute a "new grant" of an equity appreciation right, triggering a new requirement to determine whether the exercise price is equal to the fair market value on the date of grant. We appreciate the initial guidance on modification of equity rights in the context of a corporate transaction, provided in Notice 2005-1, Q&A-4(d), but suggest that more is needed. Before the enactment of section 409A, outside the context of incentive stock options, it has made little difference for tax purposes whether an option is considered a new grant or an amendment, since under section 83, the disposition of one option for another would not result in income. Similarly, an exchange of one SAR for another also would not generally result in income, so long as the exchange did not result in constructive receipt.

In particular, we suggest that guidance provide that a change in the terms of the option is not considered the grant of a new option unless the amendment increases the intrinsic value of the option or extends the option term beyond the full initial term of the option. Under this approach, for example, an amendment to allow a terminating or retiring employee additional time to exercise an option after termination of employment would not be treated as the grant of a new option

provided that the additional time is not an extension of the full option term. Similarly, it would not be the grant of a "new option" for an employer to allow additional methods for exercise, such as through tender of previously owned shares, use of a note, or cashless exercise.

We also suggest that future guidance explicitly provide that acceleration of vesting is not considered the grant of a new option. Acceleration of vesting is not a modification under the incentive stock option regulations. Also, acceleration of vesting does not create issues under section 409A in general, as provided in Q&A-15 of Notice 2005-1, unless it is used as a method for impermissible acceleration of distribution, something that is not applicable with respect to a grant that is excepted from the definition of deferred compensation.

This standard is more generous than that applicable to modifications of statutory options. Those requirements were adopted for a different purpose, however. The purpose of section 409A is to regulate access to and control over deferred compensation. Changes in exercise method or an employer's decision to waive provisions that would accelerate the term of an option do not fundamentally change the nature of the option grant, and thus should not be treated for this purpose as a new grant.

Features that Provide for Deferral. The exceptions for options and SARs in Notice 2005-1 include the requirement that the grant cannot include a feature that provides for deferral of compensation. To the extent that this provision remains a requirement of an ongoing exception for equity appreciation rights, further guidance is needed on the scope of this restriction.

As discussed in our earlier comment, we disagree that there is a reason under section 409A to restrict deferrals of equity appreciation arrangements. In any event, we suggest that the guidance should clarify that changes in form of an option or SAR through cancellation of the equity appreciation right in exchange for deferred compensation should not be considered a feature for deferral of compensation if there is no deferral beyond the term of the option, provided that the remaining arrangement otherwise complies with section 409A.

This issue often arises in business transactions. For example, assume that seller's employees hold options. Buyer may not want to issue replacement options, perhaps because of securities law concerns or perhaps simply because it does not use options as a compensation arrangement. On the other hand, the buyer may not want to cash-out all options – perhaps vesting is not being accelerated, or perhaps the buyer does not want to use the cash that would be required. Instead, it should be permissible for the employer to convert the options to SARs, which provide the same terms as the option regarding appreciation and term, adjusted as necessary to reflect

the share price of buyer's stock. Such a change from one form of equity appreciation right to another does not change the substance of the arrangement, or create deferred compensation. Alternatively, the employer might convert the options to deferred compensation with a fixed balance, establishing fixed distribution dates.

In these examples, the employee is not advantaged by the transaction. To the contrary, the employee may be losing the flexibility to hold the option as long as initially expected, or the ability to receive stock rather than a cash payment. Significantly, the employee is not getting additional intrinsic value or additional equity grants, and is not gaining an ability to defer beyond the initial term of the option. Thus, these adjustments should be permissible.

The examples above are in the context of business transactions. Given the protections in the proposed standard against increase in spread or extension of the option term, however, we do not think it is further necessary to limit the ability to make such a substitution to the transaction setting.

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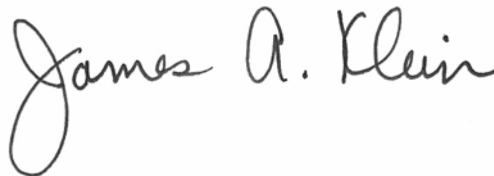
Thank you, in advance, for consideration of our comments. The issues related to equity compensation and section 409A are extremely important to our members and we hope that you will contact us if we can provide further information or input or if you have questions about issues raised in this comment letter.

Sincerely yours,



James A. Klein
President

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