



January 3, 2005

**VIA HAND DELIVERY**

Internal Revenue Service  
CC:PA:LPD:PR (REG-158080-04)  
Room 5203  
PO Box 7604  
Ben Franklin Station  
Washington DC 20044

**Re: Comments on Proposed Regulations Issued Pursuant to Section 409A –  
Treatment of Stock Options**

Dear Sir or Madam:

TechNet is a national network of 200 chief executive officers and senior partners of the nation's leading companies in the fields of information technology, biotechnology, venture capital, investment banking and law. We are proud of the role that our industries have played in the growth of the U.S. economy, due in large part to the use of broad-based stock option and other equity-based incentive plans to attract and retain talented employees. By giving employees at all levels a chance to share in their company's financial success through equity ownership, broad-based stock option plans boost productivity and are essential to America's competitiveness and economic growth. As a result, any provision that impacts employee stock options is of critical importance to our membership.

TechNet offers its comments and request for additional clarification on the proposed regulations regarding the application of section 409A of the Internal Revenue Code of 1986 to nonqualified deferred compensation plans (the "Proposed Regulations").

**Recommendations**

The Proposed Regulations provide helpful guidance with respect to the treatment of stock options and recognize a fundamental concern regarding the difficulties inherent in valuing private company stock. Notice 2006-4 also is helpful. However, TechNet believes that additional guidance is still necessary and recommends that future regulations and guidance address the following issues:



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1. Section 409A should not apply retroactively to any stock options granted on or before December 31, 2004. In addition, stock options granted by private companies prior to the effective date of final regulations should be exempted from section 409A if the options were granted at fair market value as established in good faith by a company's board of directors (or its committee);
2. If all options granted prior to December 31, 2004 are not excluded from section 409A, the transition period to make adjustments to options granted prior to December 31, 2004 should be extended to 30 days following publication of final regulations;
3. The definition of "stock of the service recipient" should include any form of common stock, except for common stock that provides the stockholder with a liquidation preference or a claim for a dividend prior to the claim of other common stockholders, disregarding any vesting provisions;
4. The only transactions or events that should negate the presumption of reasonableness of a company's prior illiquid stock valuation are those in which the company enters into a definitive agreement relating to a change in control event (that is not terminated) or if the company files a Form S-1 under the Securities Act of 1933, as amended, with respect to its stock (that is not withdrawn);
5. Specific non-exclusive examples of those with sufficient knowledge, experience and skill in valuing illiquid stock of a start-up corporation should be given; and
6. Options subject to section 409A should only trigger income inclusion at the time the option is exercised and any penalties should only be imposed on the amount of the initial discount.

**I. Section 409A Should Not Be Applied Retroactively**

**A. Recommendations**

We recommend the following:

- (1) Section 409A should not apply to any employee stock options granted on or prior to December 31, 2004.
- (2) For private companies, section 409A should also not apply to options granted prior to the effective date of final regulations if the options were granted at fair market value as established in good faith by a company's board of directors.



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**B. Explanation**

The final regulations should establish prospective standards with respect to stock options and should not apply to any options granted by any company (public or private) on or before December 31, 2004. For private companies, all options granted prior to the effective date of final regulations also should be exempt from section 409A if the fair market value of the underlying stock is established in good faith by a company's board of directors.

As a matter of policy, the regulations should not apply retroactively. This is particularly true where, at least with respect to employee stock options, the provisions of the Proposed Regulations would represent a sea change in the definition of deferred compensation.<sup>1</sup>

In addition, all options outstanding as of December 31, 2004 were granted before any final regulatory guidance was issued and many of those options were granted prior to the enactment of 409A itself. Under section 409A, the penalties for non-compliance are onerous and they would apply not to the company issuing the employee stock options, but to the employees receiving those options. Changing the rules applicable to employee stock options after-the-fact presents significant issues of fairness when the penalties are imposed on employees who had no control over their employer's actions.

For private companies, the issues of fairness are even more acute. If section 409A were to continue to apply to unvested options granted prior to December 31, 2004, private companies would be required to audit all past stock option grants and to create detailed documentation, after the fact, of all of their fair market valuations to reduce their employees' exposure to potential adverse tax penalties. This would be extremely expensive and time-consuming and still would not provide absolute certainty. Although the good faith language of Notice 2006-4 is helpful, it will not eliminate the need for private companies to engage in this extremely costly exercise. Moreover, significant controversies are still likely to arise over whether the "good-faith" standard was satisfied.

For all of the above reasons, TechNet believes that any unvested options granted prior to December 31, 2004 should be exempt from the provisions of section 409A.

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<sup>1</sup> Such treatment also would be consistent with effective date provisions used in other circumstances. See, e.g., section 162(m) where compensation paid pursuant to a binding written contract in effect as of a date certain is exempted. See also transition rules applicable to section 457. Employee stock options should not be subject to less favorable effective date provisions than have been applicable in other circumstances.



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Because the Proposed Regulations' valuation standards are significantly different than most private companies' past valuation practices, section 409A also should not apply to most option grants made after December 31, 2004 but prior to the effective date of final regulations. Because of the lack of formal guidance on stock valuations, private companies should not be forced to reexamine their 2005 grants (for the reasons discussed above) or be left with uncertainty as to whether grants made before the issuance of final regulations will subject their employees to significant penalties. TechNet believes that any options granted after December 31, 2004 and before the issuance of final regulations should be exempt from the provisions of section 409A if the fair market valuations were made in good faith by the company's board of directors (or a committee thereof). We recognize that Notice 2006-4 does help to clarify this point, however, as discussed in Section V, below, additional clarification of the "requisite knowledge" standard is necessary.

## **II. Transition Period**

### **A. Recommendation**

If all options granted prior to December 31, 2004 are not excluded from section 409A, we recommend that the transition period to "fix" any options issued prior to December 31, 2004 should be extended until at least 30 days after the publication of final regulations.

### **B. Explanation**

As noted, if all options granted prior to December 31, 2004 are not excluded from section 409A, private companies will be forced to undertake an expensive and time consuming audit of past grant practices to determine whether prior options are now subject to section 409A. As a result of this process, many private companies may determine that options granted on or prior to December 31, 2004 were inadvertently or arguably granted at a discount or discover that the company does not have any records to support a prior valuation. Because the Proposed Regulations were issued in late September 2005, we believe that many private companies did not have adequate time to review their grant practices, develop a solution and notify and receive elections from employees. Thus, we believe that the transition relief for certain stock option "fixes" should not have ended on December 31, 2005. Future guidance should permit companies to "fix" options granted prior to December 31, 2004 for at least thirty days after the publication of final regulations. During this transition period, companies also should be allowed to compensate employees in connection with any adjustment made to the exercise price of an option.



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### **III. Definition of Stock of the Service Recipient**

#### **A. Recommendation**

The definition of "stock of the service recipient" should include any form of common stock, except for common stock that provides the common stockholder with a claim at the time of a liquidation or a dividend prior to the claim of other common stockholders, disregarding any vesting provisions. In addition, the proposed regulations should clarify that stock of a service recipient that is subject to repurchase rights at original cost (or at the lesser of original cost or the then current fair market value) can qualify as illiquid stock of a start-up corporation.

#### **B. Explanation**

The Proposed Regulations provide that if common stock of a service recipient is not publicly traded, then only the class of common stock of the service recipient that has the greatest aggregate value of common stock of such service recipient, or common stock with substantially similar rights to stock of such class, is considered "stock of the service recipient." Many private companies place restrictions on common stock held by service providers that do not defer compensation and are different from restrictions placed on common stock held by other service providers. These restrictions are commonplace for private companies and we fear that the limitations imposed by the Proposed Regulations on the issuance of common stock with such features will further limit the use of options by private companies, which will limit the ability of private companies to compete for talent. For example, many private companies place transfer restrictions and post-termination purchase rights on common stock held by some employees and not others. We do not believe that these restrictions should cause common stock to fall outside the definition of "stock of the service recipient" and cause an option to be deferred compensation or outside of the definition of "illiquid stock of a start-up corporation." Instead, the Proposed Regulations should only limit the use of different classes of common stock where a class or form of common stock is essentially preferred stock and provides the common stockholder with a claim at the time of liquidation or a dividend prior to the claim of other common stockholders, disregarding any vesting provisions.

### **IV. Illiquid Stock of a Start-Up Company**

The illiquid stock provisions in the Proposed Regulations are very helpful and address many of the concerns and uncertainties that arise in valuing private company stock. However, we believe that further clarifications are necessary.



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**A. Recommendation**

The presumption that a valuation of the illiquid stock of a start-up company was made reasonably and in good faith should only be overcome if at the time such valuation is applied:

- (1) The company has entered into a definitive agreement relating to a change in control event (as described in the Proposed Regulations), unless such agreement is terminated; or
- (2) The company has filed a Form S-1 under the Securities Act of 1933, as amended, with respect to its stock, unless the Form S-1 is withdrawn.

**B. Explanation**

The Proposed Regulations provide that illiquid stock valuations will no longer be presumptively reasonable if at the time the valuation is applied the company or the stock recipient “reasonably anticipates” that the company will undergo a change of control or make a public offering within 12 months. A truly objective standard is the only way to provide certainty to taxpayers and to eliminate the otherwise inevitable controversies that will arise in interpreting this standard. The clarifications could be accomplished through explicit language in the final regulations or by way of examples.

An objective standard could be established in the context of a change of control event. We believe that such an objective standard is necessary because many private companies engage in informal merger or acquisition discussions that quickly end. Without an objective standard, significant audit controversies are likely to arise. Entering into a definitive agreement is clear evidence that a change in control event is “reasonably anticipated.” We recommend that the regulations provide that a company is deemed to “reasonably anticipate” a change in control event 30 days prior to entering into a definitive agreement. This objective standard would eliminate the uncertainty contained in the Proposed Regulations and would prevent companies from issuing significant option grants just before a sale or merger but it would not unduly punish private companies.

The regulations also should provide more clarity in the context of a company that plans to go public. We recommend that the regulations either clearly state or set forth an example that provides that the 12-month period begins on the date the company files a Form S-1 (that is not withdrawn). This event is clear, unambiguous evidence of “reasonably anticipating” going public and will eliminate the uncertainty that currently exists.



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**V. Requisite Knowledge and Experience in Valuations of Illiquid Stock**

**A. Recommendation**

The provisions in the Proposed Regulations clarifying that private companies are not required to use outside valuation experts are very helpful. We would, however, recommend that the final regulations provide at least some non-exclusive examples of persons who would qualify as having “significant knowledge and experience” in performing valuations of illiquid stock. Examples that we believe should be included are (1) a venture capital board member and (2) a company’s senior internal accounting personnel who possess advanced professional degrees or other valuation experience or who are applying a valuation methodology used in a prior independent appraisal or developed for the company by an outside expert.

**B. Explanation**

The Proposed Regulations are very helpful in confirming that a start-up company does not need to hire outside valuation experts and providing a presumptively reasonable valuation method for the illiquid stock of a start-up corporation. However, we believe that the regulations could be clarified to eliminate uncertainty as to what would satisfy the standard of having “significant knowledge and experience or training in performing similar valuations.”

Our membership contains many venture capital firms and venture-backed companies. In our view, a venture capital board member would be an example of a person who possesses “significant knowledge and experience or training.” Venture capital board members are generally industry experts and know the company’s business better than virtually anyone else. They also invest in start-up companies and have to value them frequently. An example clarifying that a board member who is a venture capitalist is deemed to have the requisite knowledge and training in illiquid stock valuations would help to clarify the requisite knowledge and experience standard.

A company also should have the flexibility to have senior accounting personnel perform a valuation of the company’s stock. Senior accounting personnel should also be deemed to satisfy the requisite knowledge standard if they possess a level of expertise demonstrated by industry experience and/or formal education. An example clarifying this point would be very helpful. In addition, a valuation performed by an internal accountant should also be deemed to be made reasonably and in good faith if the methodology used was developed for the company by an outside expert and there have been no significant changes in circumstances that would impact the validity of the methodology.



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## **VI. Income Inclusion and Calculation of Penalties for Stock Options**

### **A. Recommendation**

Although the Proposed Regulations do not address the time of income inclusion and the calculation of penalties with respect to stock options that may be subject to Section 409A, we understand that these issues will be addressed in future guidance. However, given the importance of this issue to our membership, we offer several points for your consideration at this time.

To the extent that a stock option is subject to section 409A, income inclusion and taxation should occur only on the date of exercise and the penalty should be limited to the difference between the fair value of the stock on the date of grant and the exercise price of the option.

### **B. Explanation**

Employees could have significant liquidity problems if options subject to section 409A are to be taxed upon vesting, rather than upon exercise. The burden on an employee of a private company that does not make a market for its stock is incredibly onerous. In most private companies, an employee cannot exercise stock options on the date they vest in order to pay any resulting tax liability, regardless of the then value of the underlying stock. An employee cannot gain any liquidity when a market does not exist for the stock.

Another significant problem with the recognition of income upon vesting for all options, whether the company is public or private, is that an employee who recognizes income when a discounted option vests may have to pay taxes on income that never is realized because of downturns in the value of a company's stock between the date of vest and the actual exercise date. We believe that it is unfair to tax employees on income that may exist on paper at the time the option vests but which they may never realize. Such a result seems particularly unfair in light of the fact that in most instances employees have no control over whether options received are subject to section 409A. Because of this inherent unfairness and the nature of options, we recommend that the employee only be taxed on the date an option is exercised.

Taxing employee stock options subject to section 409A when they vest would also create significant administrative and procedural problems. Private companies would be required to value their stock upon each option vesting date in order to determine tax liabilities and penalties to be imposed on their employees. Employees also would presumably be forced to recompute their tax liability when they actually exercise their stock options. If the value of the stock declined they would presumably be entitled to a refund. Would they also be entitled to a refund



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of any penalties imposed on income that they did not, in fact, recognize? Adding this level of additional complexity to the taxation of rank and file employees simply makes no sense. These unnecessary administrative costs and burdens are further reasons why options should be taxed only when, and if, they are exercised.

Any penalty also should be imposed only on the difference between the fair market value on the date of grant and the exercise price of the employee stock option. We recognize that our recommendation would subject employee stock options to different treatment under section 409A than would be applied to other nonqualified deferred compensation, but such different treatment is consistent with the unique treatment afforded options under other sections of the Internal Revenue Code. Even prior to section 409A, the Code recognized that certain types of options require different income inclusion rules. Under section 83, options with no “readily ascertainable fair market value” have been subject to different income inclusion rules than other property received by an employee. We believe the same valuation considerations that support different treatment under section 83 require different income inclusion rules under section 409A.

The penalties assessed on options subject to section 409A should also be treated differently than other nonqualified deferred compensation. The penalty imposed under section 409A on options should be limited to the initial discount (rather than on the spread between the exercise price of the option and the fair market value of the underlying stock on the vesting date). Unlike other forms of nonqualified deferred compensation where a participant affirmatively elects to defer income, an employee rarely controls whether or not they receive an option subject to section 409A. In many cases, an employee will not even be aware that an option was granted at a discount until such grant is challenged long after the fact and viewed in hindsight. In addition, unlike other deferred compensation plans, any additional value in the underlying stock from the date of grant until the date of vesting is not linked to the amount of the initial discount. Conversely, the amount of an initial deferral under a nonqualified deferred compensation plan will directly influence the amount of any earnings on such deferral.

For private companies, fairness also dictates this result. Given all of the difficulties inherent in valuing private company stock, it would simply be unfair for the employee to be subjected to extremely onerous penalties if his or her employer’s stock valuation were challenged and the IRS were successful in showing that the stock was misvalued by as little as a penny. Because the “discount” is what creates the deferral, only the “discount” should be subject to any penalties.

For all of these reasons, we believe that employees should only be subject to income inclusion upon exercise of an option and that any penalty should be limited to the initial discount.



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Thank you in advance for this opportunity to express our concerns and recommendations with respect to future regulations under section 409A. We welcome the opportunity to discuss these issues with you in greater detail.

Sincerely,

A handwritten signature in black ink that reads "Lezlee Westine". The signature is written in a cursive, flowing style.

Lezlee Westine  
President and CEO

cc: Eric Solomon (Treasury)  
Nancy J. Marks (IRS)  
Daniel Hogans (Treasury)  
Stephen Tackney (IRS)  
William Schmitt (IRS)