



January 3, 2006

VIA HAND DELIVERY

Honorable Mark W. Everson  
Commissioner  
Internal Revenue Service  
CC: PA:LPD:PR (REG-158080-04)  
1111 Constitution Ave, NW  
Washington, DC 20224

Re: **Comments on Proposed Regulations for Section 409A: Application to Stock Options**

Dear Commissioner Everson:

On behalf of the Biotechnology Industry Organization (BIO) and our member companies, we appreciate the opportunity to submit comments on the proposed regulations under the Internal Revenue Code (IRC) Section 409A<sup>1</sup>, and more specifically regarding the treatment of stock options valuation for private companies.

BIO represents more than 1,100 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health-care, agricultural, industrial and environmental biotechnology products. The majority of our member companies are privately held.

Many of our member companies are small, private, research- and- development oriented companies that are eager to attract scientific talent, investment, and corporate partners to grow into the next generation of Fortune 500 firms. The issues and recommendations proposed in this comment letter are critical to our member companies, and the manner in which they are addressed by the IRS could affect the growth and vitality of the biotechnology industry in the United States.

**Role of Stock Options for Private Biotech Companies and Valuation Concerns:**

Many early stage biotech companies serve as a critical source of innovation for the industry in general. The risk is high for many of the investors and the employees as most of the early stage biotech companies are not fully funded to carry projects through all phases of product development. Given the high risks,

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<sup>1</sup> Comments are in response to the request for comments made by the Internal Revenue Service (IRS) in Notice of Proposed Rulemaking dated October 4, 2005 (Proposed Regulations) issued under section 409A of the Internal Revenue Code of 1986, as amended.

stock options have provided the needed compensation incentive for early stage biotech companies to attract the best talent and gain a commitment from their employees to ensure the company's success. In fact, many early stage companies provide stock options to all of its employees in lieu of formal, revenue-based bonus plans, 401 (k) company matches, and "large-company salaries", and they fear that without the ability to maintain such incentive plans, they will not be able to maintain the workforce necessary to remain competitive.

The implications of section 409A, which imposes income tax liability and penalties on the employees who presumably receive below fair market value stock options, will have a chilling impact on the industry's ability to explore cutting edge innovations in biotechnology. If the proposed regulations are not further clarified and implemented appropriately, it will hinder the entrepreneurial spirit of the best and the brightest talents who could be working toward a cure for many of the ailments facing Americans today.

### **Recommendations for Clarification and Revision of Proposed Rules:**

In order for early stage biotech companies to remain competitive, it is critical that the fair market valuation rules for the purposes of triggering Section 409A be further clarified and revised as recommended below:<sup>2</sup>

**Recommendation #1:** Valuation of illiquid stock options of a start up company should be presumed to be reasonable and in good faith if performed by the company's senior financial officials or by the members of the board of directors who have the "significant knowledge and experience" in performing valuations of illiquid options for the company and the industry.

**Rationale:** Given the event-driven nature of the biotech industry and the huge volatility in the industry's external valuation models, it is critical that the fair market valuations are performed by those who have the requisite knowledge and experience with the industry and the company and by those who have the ability to weigh the factors that determine the fair market value of private company options.

**Recommendation #2:** The proposed rules should be further clarified to definitively state that no independent appraisal is required.

**Rationale:** As noted above, given the volatility and the lack of external valuation standards for private company stock, we believe that company officials or the members of the board are in the best position to determine the fair market value of their common stock. Hiring an external appraiser would not only be costly, as most companies would need to invest upwards of \$100,000 in additional costs, it may also cause more confusion since there are no existing guidelines on who may qualify as an "independent" appraiser and what valuation standards the appraiser should use.

**Recommendation #3:** The proposed rules regarding the reasonable expectation of a change in control or public offering should be clarified. The presumption of reasonableness and good faith valuation may be subject to question only if a company has entered into a definitive agreement or filed its registration statement with the SEC at the time of the valuation or within 15 -30 days of the valuation.

**Rationale:** As we discussed above, many early stage biotech companies serve as incubators of innovation for more mature biotech and pharmaceutical companies. As such, many early stage companies are often courted by potential industry partners or investors regarding public offering opportunities, which may not

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<sup>2</sup> Proposed recommendations seek to clarify the valuation requirements set forth in the proposed regulations sections (b) (5) (iv) (B) (1) and (2).

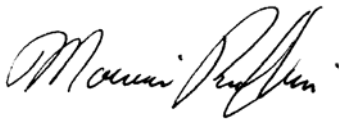
result in any outcome or change of control. Thus, a clear action triggering event such as a formal agreement or filing of a registration statement with the SEC, which is not withdrawn or cancelled, would provide much needed certainty and clarity on when the presumption of the valuation could arguably be questioned.

**Recommendation #4:** The application of section 409A should be prospective and all options granted by a private company based on a good faith valuation prior to the final rule publication date should be exempted from 409A.

**Rationale:** Given the volatility and the lack of industry standards on the valuation of private company stock and the lack of formal guidance on such valuations, it is critical that all options granted by a private company prior to the date of the final rule publication be exempted from section 409A. Having the rules apply retroactively, where no clear guidance was provided, would unfairly punish companies and employees who have played by the rules and have made good faith efforts to comply without settled guidance.

As we discussed above, the appropriate treatment of stock options valuation within the context of Section 409A is critical to maintaining the competitiveness and ultimately the success of the biotech industry in the United States. We thank you in advance for your consideration of our comments and recommendations on the proposed regulations for Section 409A. If you have further questions, please contact me or Lauren Choi, BIO Director of Capital Formation Policy at (202) 962-9200.

Sincerely,



Edmund M. Ruffin  
Executive Vice President  
Capital Formation and Business Development  
Biotechnology Industry Organization