September 21, 2016

The Honorable Erik Paulsen
127 Cannon House Office Building
Washington, DC 20515

The Honorable Joseph Crowley
1436 Longworth House Office Building
Washington, D.C. 20515

Re: HR 5719 Comment Letter

Dear Representatives:

Thank you for your interest to assist closely-held corporations attempt to attract qualified talent through offering equity ownership and delaying the payment of the resulting tax liability. HR 5719 was approved by the House Ways and Means Committee and is moving through Congress,[1] although it is opposed by the White House for increasing the deficit without an offset. In reviewing the bill, some unattractive features to the proposal became apparent that should be considered and understood as this legislation is considered.

The bill would delay the taxation, income tax withholding, and employer deduction relating to certain compensatory equity awards by start-up and certain other close-held corporations until a later date when the company is expected to be more operational. The bill has received favorable support as a method to "help startup companies attract and keep top talent by allowing employees to defer the taxes on their stock options until they are likely to have the funds necessary to make their tax payment."

The proposal is intended to provide welcome tax relief, but its implementation would (1) be limited to corporations that have a very broad employee stock ownership program, (2) impose onerous reporting and monitoring obligations of start-up companies, and (3) not necessarily tie the employee tax obligation to when cash is available.

The following is not an exhaustive analysis of the bill, but contains sufficient detail to illustrate its complexity and the challenges that it raises.

SUMMARY OF UNATTRACTIVE FEATURES.

As drafted, this bill would :

1. Impose continual employer reporting and monitoring requirements that are difficult for start-up corporations to administer. Some of the continual employer reporting requirements are listed below.

[1] The House bill was revised by the Chairman's amendment in the nature of a substitute to the original bill.

2. Automatically be applicable to "eligible corporations" and impose obligations on small businesses who have certain outstanding compensatory arrangements and new grants to notify all "qualified employees," with possible penalties for failure to notify.

3. In certain cases, impose tax withholding obligations on the employer with respect to the delayed taxable amount when qualified employees are no longer employed, rather than when other cash compensation is available to withhold.

4. Delay the employer tax deduction related to qualified equity awards until the employees delayed income recognition occurs.

5. In certain instances, result in employee taxation which is not necessarily linked to a liquidity event.

6. Put some employees in the unfortunate position of having a large tax liability on a future date with respect to qualified shares that have substantially declined in value.

7. Cease to be available for any future awards and outstanding unvested awards if the employer purchases certain outstanding shares.

Also, the delayed taxation proposal is available only to employees of corporations where at least 80% of all employees receive stock options or restricted stock units and is ineligible to top executives, which makes the proposal less attractive and not necessarily a very good tool in attracting qualified talent. Further, start-up corporations would have to continually determine who are the top four highest compensated officers (possibly in addition to the CEO and CFO) using the SEC compensation disclosure rules (even though such rules are inapplicable to such employers) because such employees are ineligible for this provision.

BILL SUMMARY.

If applicable, the bill allows "qualified employees" who receive equity compensation through a stock option (nonqualified or incentive stock option) and restricted stock units (e.g., phantom shares or other units payable in shares) to elect to delay the ordinary income normally associated with the issuance of vested shares until the occurrence of any of the following dates:

1. The date shares are transferable to the employer or another person[2],

[2] For this purpose, transferable seems to be merely be the ability to transfer the shares. Accordingly, the shares must be stated as being non-transferable to anyone. Currently, Section 83 delays taxation while the shares are non-transferable, but such definition is linked to whether a transferee continues to be subject to a risk of forfeiture. In contrast, qualified shares subject to a delayed income election under the new proposal would be fully vested when the election is made and the mere right to transfer would seem to negate the election.

2. The date that the employee becomes the CEO, CFO, top four highest compensated officers, or a 1% owner,

3. The date the corporation becomes a public company,

4. The date that is seven years after the shares are vested under Section 83, or

5. The date the employee revokes the election to delay income taxation in accordance with future prescribed IRS rules.

Locked-In Ordinary Income Amount. When the shares vest under the current application of the Section 83 rules, the employee's ordinary income amount is locked in at that time but such income is not reported by the employee nor is withholding applicable until the occurrence of one the events listed above. The employee does not pay interest to the IRS on the delayed tax reporting.

Section 83(i) Election. An employee would make an election to apply this provision by a filing with the IRS within 30 days after such shares vest—just like a Section 83(b) election. While a Section 83(b) election is made within 30 days after the restricted shares are issued, the election available under the bill –a Section 83(i) election—would need to be made within 30 days after the shares vest. The filed Section 83(i) election would also need to include the electing employee agreeing to satisfy the tax withholding requirements when the delayed taxation date occurs. The tax withholding is based on the maximum income tax rate in effect for the year that the above listed event occurs, even if the employee's aggregate income is not subject to the highest income tax rate.

FICA Taxes. If an employee makes the Section 83(i) election, FICA taxes must nonetheless be paid when the shares vest for Section 83 purposes and not when the resulting ordinary income is included in income. Accordingly, both for the calculation of FICA taxes and to determine the locked-in ordinary income amount, the value of the employer shares must be established on the Section 83 vesting date.

Delayed Income Recognized on Certain Non-Liquidity Dates. Some of the listed taxation events above are not linked to liquidity (e.g., 7th year anniversary of vesting date, advancement to certain executive positions), which means that certain employees could be in no better position than under the current rules. However, they might have more time to plan for the payment of taxes.

Capital Gain Holding Period. While not specifically addressed, the holding period for future capital gain would seem to commence whether the shares vest for normal Section 83(b) purposes (i.e., when the ordinary income amount is calculated), and any additional appreciation following that date is eligible for capital gain.

Problem where Share Value Declines Following Vesting Date. If the share value declines following the vesting date, the employee is nonetheless required to pay taxes based on the higher fixed ordinary income amount calculated when the shares vest.[3] The employee may delay the resulting tax date for seven years but the problem in the case of declining share value will arise eventually. Also, when the shares declined in value following the vesting date, any subsequent sale of such shares would result in only a capital loss and not offset the delayed ordinary income.

Election Not Available for Restricted Shares. The bill is available only for stock options and restricted share units. As drafted, it is not applicable to compensatory restricted shares issued either outright or subject to vesting conditions but not tied to a prior restricted share unit grant. While restricted shares might be less common for closely-held corporations, it would seem that the same underlying reasons for the proposal should equally apply to restricted shares.

Section 409A Could Deny Election Procedure in Certain Situations. The bill states that an election to delay the reporting of ordinary income with respect to shares received from the exercise of stock options or the share payout from restricted stock units does not create a Section 409A deferred compensation arrangement. However, certain restricted stock unit arrangements can create a Section 409A arrangement (e.g., there is a delayed payout past the vesting date) separate and apart from any delaying income election. In such a case, a deferred compensation arrangement is in effect for Section 409A purposes and the ordinary income must be reported in income on the fixed payment date. It would seem that the election under the new provision would not be available in such context. This 409A override would not arise in connection with most stock options.

Not Available to Private Corporation that Transitioned from Public Company Status. Corporations whose shares are publicly-held and then undergo a transition to become a closely held corporation are ineligible corporations.

Overlap with Section 423 Awards. Employers who adopt broad based equity award programs would need to consider whether such arrangements qualify for the benefits already available under Section 423.

Employer Required Monitoring and Notifications. The following are employer reporting and monitoring obligations that eligible close-held corporations would have to implement. These reporting requirements seem impracticable for most start-ups.

[3] This is similar to the potential dilemma for incentive stock options under Section 422, where the AMT tax liability is triggered on the exercise date based on the spread at that time and the resulting AMT credit might not be available if the share value drops by the eventual sale date.

a. Employers need to monitor annually whether stock options and RSUs are available to more than 80% of their employee population, not taking into account certain part time employees and certain top executives.

The bill is effective for qualified shares issued on the exercise of stock options and the settlement of restricted stock units after December 31, 2016. Accordingly, closely-held corporations that have equity awards outstanding would have to review whether currently outstanding stock options and restricted stock units would be eligible for the election commencing in 2017.

b. For eligible corporations, the employer must monitor when the vesting event occurs, when the "qualified employee" becomes an excluded employee, and when the 7 year anniversary of the vesting date occurs to ensure that the proper income tax withholding and Form W-2 reporting occurs.

c. Employers that have qualified arrangements in place would terminate the employees' ability to make future elections to delay the timing of taxable income by acquiring its outstanding shares in certain situations.

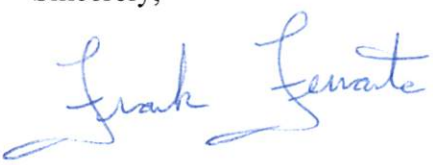
d. On the vesting of shares issued pursuant to the exercise of stock options or in settlement of restricted stock units, employers must provide "qualified employees" with (i) notification certifying such stock as "qualified shares," (ii) notification that an election to delay ordinary income recognition is available, which would need to state how the ordinary income amount is determined, that the ordinary income amount is subject to applicable tax withholding requirements on the future enumerated date, and that the employee must satisfy such tax withholding obligation, along with an employee agreement that the tax withholding requirement will be met, and (iii) a Form W-2 for the year that the shares vest stating the amount of income excluded pursuant to an election, a Form W-2 for each year between the year the election is filed and the year that the deferral amount must be included in income showing the deferred income amount, and a Form W-2 for the year that the deferred income must be included in income showing the recognized income amount.

ALTERNATIVE APPROACH.

The bill is intended to achieve the important goals of attracting and retaining talented employees and increasing equity ownership. Consideration should be given to revising the bill to expand the eligible employees and reduce the administrative burdens it imposes on employers. While its budgetary consequences would need to be considered, an alternative would the application of a lower tax rate to some simpler form of "qualified shares" using the Section 83(b) reporting date under current rules and either a reduced or no deduction at the employer level for the "qualified shares."

This letter is written with respect to a subject matter that is part of my practice and presents my individual views only. I hope these points assist the discussion regarding this important bipartisan effort that you are undertaking.

Sincerely,



Francesco A. Ferrante

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