Congress Considers Legislation to Postpone Taxation of Private Company Equity Awards

On July 11th of this year, bills were introduced in the United States Senate and House of Representatives that seek to address an issue that has become a problem for many employees of privately-held companies who hold outstanding equity awards granted to them during their employment. The "Empowering Employees through Stock Ownership Act" (S. 3152, introduced by Senator Mark Warner (D-Virginia) and Senator Dean Heller (R-Nevada), and HR 5719, introduced by Representative Eric Paulsen (R-Minnesota)) would allow these employees to overcome the lack of liquidity for their companies' shares by deferring for up to seven years the taxes that arise on the exercise of certain employee stock options and the vesting of restricted stock unit awards.

Copies of the draft bills (which were virtually identical prior to the amendment of the House version on September 14, 2016) are available below:

Download a PDF on S. 3152 »

Download a PDF on HR 5719 »

Significance of Bills

While most technology start-ups and other privately-held companies consider equity awards to be a critical competitive tool for recruiting and motivating their employees, current tax rules can create challenges for these employees as they earn their awards – particularly in the absence of a means for converting their earned awards into cash. Specifically, employees face the following problems:

- If they exercise a non-qualified stock option, they are required to pay taxes at the time of exercise based on the difference between the purchase (exercise) price and the fair market value of the option shares on the date of exercise, in addition to the option exercise price.
- If they were granted a restricted stock unit ("RSU") award, they are required to pay taxes at the time the award vests based on the fair market value of the shares on the date of vesting.

For companies that are publicly-traded, employees can sell all or a portion of their shares on the public market to satisfy their tax liability (and, in the case of a stock option, to pay the option exercise price). In the case of privately-held companies, however, generally there is not a market for the employees to liquidate their shares to cover these amounts. Consequently, they have to pay these amounts out of their own pocket with no assurance that the shares will ever be marketable or, even if they become marketable, that at the time of sale they will be worth the same value as at the time of exercise or vesting.

For this reason, most employees tend to delay the exercise of their stock options until the company goes public. In addition, since employees do not control the timing of vesting and the corresponding taxable event in the case of RSU awards, they tend not to be used until a privately-held company reaches a fairly significant valuation. Moreover, where

House of Representatives Approves "Empowering Employees Empowering through Stock Ownership Act"

As we were going to print, the House of Representatives approved HR 5719, the 'Empowering Employees Empowering through Stock Ownership Act.' In spite of Democratic opposition (including that of the bill's two principal Democratic co-sponsors) because of the bill's failure to address how to pay for the lost or delayed income, the measure passed in a 287-124 vote on Thursday, September 22nd. The spotlight now shifts to the Senate, which has yet to take up its version of the bill, S. 3152.

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used, the awards tend to be designed to postpone the taxable event until there is liquidity for the company's shares.

In the case of stock options, this dilemma is compounded when an employee leaves the company as typically their stock options require that any vested shares be purchased within 90 days following termination of employment or risk forfeiture.

Citing employee ownership as a means for strengthening business growth and creating new economic opportunities, especially for rank-and-file workers, the bills seek to address these problems by giving employees some badly-needed flexibility in handling their tax obligations. Specifically, the bill would allow most employees to defer their income tax liability for up to seven years after exercising their stock options and vesting in their RSU awards. Further, the bills seek to promote broad-based employee ownership by requiring companies to grant equity awards on essentially similar terms to 80% or more of their employees on an annual basis.

Summary of Bills

S. 3152 and HR 5719 would amend Section 83 of the Internal Revenue Code to add a new subsection (i) thereto. This subsection would permit most employees of privately-held companies that satisfy certain conditions to elect to defer the taxation of company stock received upon the exercise of a stock option or the vesting of an RSU award that was granted in connection with their employment. The most important feature of the bills are as follows (changes to the initial version of HR 5719, which were approved by the House Ways and Means Committee on September 14, 2016, are noted):

- **Deferral election** – An employee of an "eligible company" (as defined below) who receives "qualified stock" (as defined below) upon the exercise of a stock option or the settlement of an RSU award may elect to defer taxation on the receipt of such stock until the earliest to occur of;
  - the date the stock is sold or otherwise transferred (HR 5719 instead provides the first date the stock becomes transferable (including transferable to the company));
  - the date the employee first becomes an "excluded employee" (essentially, a large (1% or more) shareholder or an executive officer);
  - the first date on which any stock of the company becomes readily tradable on an established securities market;
  - the date that is seven years after the first date the stock option or RSU award vests; or
  - the date on which the employee elects to include the amount in income (HR 5719 instead provides the date on which the employee revokes his or her deferral election).
- **Eligible company** – To make a deferral election, the stock option or RSU award must be granted by a company that:
  - Does not have its stock traded on an established securities market in the calendar year of grant or award (or any preceding calendar year); and
  - Has a written plan under which not less than 80% of all employees have the same rights and privileges to receive "qualified stock" for such calendar year (HR 5719 instead provides that the company has a written plan under which, in a calendar year, not less than 80% of the company's US employees are granted stock options or RSU awards with the same rights and privileges). For purposes of determining whether employees have the "same rights and privileges," the rules applicable to Section 423 employee stock purchase plans would be used.
- **Qualified stock** – Shares subject to a stock option grant or RSU award will be considered "qualified stock" if:
  - The grant or award is made to an employee in connection with his or her performance of services for the company;
  - The grant or award is made during a calendar year in which the company was an "eligible company"; and
  - The stock is received in connection with the exercise of a stock option or the settlement of an RSU award.

  Note that if an employee may sell the stock back to the company or otherwise receive cash in lieu of the stock once the award has vested, the shares will not be considered "qualified stock."

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- **Excluded employees** – All employees of an eligible company are eligible to make a deferral election except for any individual:
  - who owns (or at any prior time owned) 1% or more of the company's outstanding shares (as determined under the "top heavy" rules for qualified retirement plans) (HR 5719 instead provides who was a 1% owner at any time during the 10 preceding calendar years);
  - who is (or at any prior time has been) the CEO or CFO of the company or related to either such individual; or
  - who is (or for any prior taxable year has been) one of the four highest-compensated officers of the company (as determined under the SEC's executive compensation disclosure rules) (HR 5719 instead provides who has been for any of the 10 preceding taxable years one of the four highest-compensated officers of the company).
- **Deferral election** – An election to defer taxation upon exercise of a stock option or the settlement of an RSU award must be made within 30 days of the date of vesting of the award. Where a deferral election is made, the employer's tax deduction is also postponed until the year in which the employee takes the deferred amount into income.

  HR 5719 introduces a new requirement stipulating that an employee may not make a deferral election for a year with respect to qualified stock if, in the preceding calendar year, the company purchased any of its outstanding stock unless at least 25% of the total dollar amount of the stock so purchased is stock with respect to which a deferral election is in effect and the determination of which individuals from whom such stock is purchased is made on a reasonable basis.
- **Notice** – A company transferring qualified stock to an employee will be required to inform the employee of his or her right to make a deferral election. Failure to provide such notice will result in a penalty.
- **Amount taxable at end of deferral period** – Assuming an employee makes a deferral election, the amount taxable at the end of the deferral period will be based on the value of the stock at the time of exercise or vesting, without regard to whether the value of the stock has declined during the deferral period.

Our Initial Observations

Although the text of the original bills were opaque, it appears that for the employees of a privately-held company to qualify for the contemplated tax deferral, in a calendar year the company must actually grant awards to at least 80% of its employees. In other words, if a company did not make a broad-based grant in a particular calendar year, none of the awards granted during that year will be eligible for tax deferral. (This interpretation of the bills is supported by the amended version of HR 5719.) Apparently, this requirement is intended to encourage privately-held companies to provide meaningful equity awards to their workforce. Further, the bills' reference to all employees having the "same rights and privileges" is potentially problematic. To the extent that this language is intended to prohibit de minimis awards to some groups of employees, it may present problems for venture-backed companies.

It is also worth noting that the bills are silent on several matters that will be of importance to the granting company and the employees receiving the awards. For example, it is not clear whether the grants or awards must conform to a specific design. Most privately-held companies structure their broad-based equity grants as simple time-based awards. Presumably, these arrangements will continue to be sufficient to ensure that the underlying shares are considered "qualified stock."

In addition, the bills do not address the form, content, or filing of the required deferral election (although the amended version of HR 5719 attempts to address some of these issues). These are details to be worked out by the Internal Revenue Service.

Finally, the bills are not entirely clear as to whether the deferral is limited to income taxes or would also cover other taxes (such as the employment taxes under FICA and FUTA). However, the Joint Committee on Taxation's description of HR 5719 indicates that a deferral election may be made for income tax purposes only. Perhaps of more interest, the Joint Committee description states that a qualified employee may make a deferral election with respect to an incentive stock option or shares purchased pursuant to a Section 423 employee stock purchase plan,

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in which case the rules relating to statutory options would not apply.

Next Steps

Following their introduction, the bills were referred to the House Ways and Means Committee and the Senate Finance Committee, respectively, for consideration. On September 14, the House Ways and Means Committee held a hearing to "markup" HR 5719. The Committee approved the bill subject to several significant amendments, as noted above.

HR 5719 now moves to the floor of the House of Representatives for consideration. While the Senate has yet to act on its version of the bill, with the November election looming, it is possible that these bills could see a final vote before Congress adjourns at the end of the month.

Need Assistance?

Compensia has significant experience in helping companies understand and address the implications of legislative and regulatory developments on their executive compensation programs. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how these policies are likely to affect your executive compensation program, please feel free to contact us. ■

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