

House Ways and Means Proposes New Restrictions on S Corporation ESOPs 11.29.07

H.R. 3970 introduced by Hon. Charles Rangel on October 25, 2007, includes a Section 3701 that would add Section 409B to the Internal Revenue Code. The new provision would create an additional income tax on the holder of synthetic equity (as defined in Section 409(p)). The new rule would provide that when the holder "exercises" the synthetic equity, in addition to any taxable gain he may recognize from the exercise of the instrument, he must also recognize a new taxable amount. That amount is calculated by determining the amount of S corporation income the holder would have recognized each year, had he held actual stock instead of synthetic equity. In addition, once that amount of additional tax liability is calculated, Section 409B imposes an interest charge on the amount at the underpayment interest rates.

Under the proposed rule, it appears that the effective federal tax rates on employee stock options could exceed 100% and the rate on employee stock appreciation rights could exceed 70%. For warrant holders, the effective federal tax rate could exceed 80%. These effective federal rates do not include state income tax.

Here are three examples of how this would work.

Executive Compensation

Stock Options – Assume a company has \$10 million in pre-tax income and the company is worth 5x income, or \$50 million. It grants an employee an option to acquire 5% of its stock. The exercise price is set at \$2,500,000, using the current FMV. Assume the company continues to earn \$10 million per year for the next 5 years, and the company is worth \$80 million at the end of 5 years. When the employee exercises his option, he is entitled to pay the \$2,500,000 exercise price and receives \$4,000,000 of stock (5% of \$80 million). Under current law, he has ordinary income equal to the spread of \$1,500,000 and, at a 35% effective federal tax rate, he owes \$525,000 in federal income tax. Under the proposed law, he would also have to include 5% of the company's annual \$10 million, or \$500,000, in his taxable income. The \$500,000 per year for 5 years is \$2,500,000. At a 35% federal tax rate, he would owe an additional \$875,000 plus the interest charge for the 5-year period.

The employee ends up with a \$1.5 million economic gain in the option for which he pays \$1,400,000 (\$525,000 + \$875,000) in income taxes plus the substantial interest charge (approximately \$175,000 depending on interest rates).

Stock Appreciation Rights – Assume the same facts as above, except the company uses stock appreciation rights ("SARs") instead of stock options to compensate executives. The original strike price for the SAR is set at \$2.5 million (5% of the \$50 million company value). When the employee is eligible to exercise the SAR in 5 years, he is eligible to receive in cash the excess of \$4 million (5% of \$80 million) over the \$2.5 million strike price. Under current law, he has ordinary income equal to the spread of \$1,500,000 and, at a 35% effective federal tax rate, he owes \$525,000 in income tax. Under the proposed law, the employee would also have to include up to 5% of the company's annual income of \$10 million, or \$500,000, in his taxable income for each of the 5 years the SAR is outstanding. The actual amount would be somewhat less because the proposed Section 409B appears to use the concept in Section 409(p) that the amount of synthetic equity owned by a SAR holder is equal to the fair market value of the spread in the SAR at a given time divided by the per share price of the company's stock. So, the SAR holder's share of the S corporation income in the first year might be relatively small, and would grow as the value of the SAR "spread" grows. Assume the value grows ratably over the 5-year period. The employee's portion of the S corporation's taxable income that would be subject to Section 409B over the 5-year period would be \$1.25 million, determined as follows: \$10 million (annual S corporation income) x 5 years x 5% (SAR ownership level) x 50% (reflecting ratable growth). At a 35% federal tax rate, the employee would owe an additional \$437,500. With the \$525,000 of federal income tax under current law, the liability on the \$1.5 million profit would be \$962,500 in income taxes plus the substantial interest charge (approximately \$87,500 depending on interest rates).

Mezzanine Lender with Warrants –

Assume the same facts as above. In addition, X Corp agrees to lend the Company \$10 million on a subordinated basis. The loan provides for 6% annual interest rate, plus a warrant to acquire 20% of the stock of the Company. The original strike price for the warrant is set at \$10 million (20% of the \$50 million company value). When X Corp is eligible to have its warrant redeemed by the Company in 5 years, it is eligible to receive in cash the excess of \$16 million (20% of \$80 million) over the \$10 million strike price. This leaves X Corp with a \$6 million economic value in the warrant. That amount would be subject to federal capital gains at 15%. Under the proposed law, X Corp would also have to include up to 20% of the company's annual income of \$10 million, or \$2 million, in its taxable income for

each of the 5 years the warrant is outstanding. X Corp's portion of the S corporation's taxable income that would be subject to Section 409B over the 5-year period would be \$10 million, determined as follows: \$10 million (annual S corporation income) x 5 years x 20% (warrant ownership level). At a 35% federal income tax rate, X Corp would owe an additional \$3.5 million in taxes plus the interest charge for the 5-year period. With the \$900,000 or so of federal capital gains tax, plus the \$3.5 million of new taxes, the liability on the \$6 million profit would likely exceed \$4.4 million. In addition, the warrant holder would owe approximately \$700,000 in interest charges.