Stock Option Taxation: The Senate's Tax Bill

Stock option taxation is a sensitive issue in startup land. Fred Wilson recently sounded the alarm about the Senate's proposal to tax stock options as they vest. TechCrunch has also written about this.

Right now, what we have to work with is the DESCRIPTION OF THE CHAIRMAN’S MARK OF THE “TAX CUTS AND JOBS ACT”.

The document lays out the proposal as follows:

> Under the proposal, any compensation deferred under a nonqualified deferred compensation plan is includible in the gross income of the service provider when there is no substantial risk of forfeiture of the service provider’s rights to such compensation. For this purpose, the rights of a service provider to compensation are treated as subject to a substantial risk of forfeiture only if the rights are conditioned on the future performance of substantial services by any individual. Under the proposal, a condition related to a purpose of the compensation other than the future performance of substantial services (such as a condition based on achieving a specified performance goal or a condition intended in whole or in part to defer taxation) does not create a substantial risk of forfeiture, regardless of whether the possibility of forfeiture is substantial. In addition, a covenant not to compete does not create a substantial risk of forfeiture.

What is interesting about this is it runs completely counter to how the world works today. Today, if you grant stock options at fair market value, there is no tax to the optionee upon receipt. Nor is there tax on vesting. But the new rule proposes taxing on vesting. This is distressing.

Incentive Stock Options Carved Out

There is some good news here. Apparently "statutory options" would not trigger this new rule. See below. Only nonqualified stock options would be problematic.

> The proposal applies to all stock options and SARs (and similar arrangements involving noncorporate entities), regardless of how the exercise price compares to the value of the related stock on the date the option or SAR is granted. It is intended that no exceptions are to be provided in regulations or other administrative guidance. However, it is intended that statutory options are not considered nonqualified deferred compensation for purposes of the proposal.

It will be interesting to see what happens here.

A Better Idea

My proposal would be: Congress should make it easier for companies to share equity with workers. I don't believe service providers should be taxed at all when they receive stock in a private company. The stock can't be sold, and generally must be held indefinitely.

If the Congress passed a sensible law, which said that service providers would not be taxed on the receipt of equity of their employer if not a registered security that was freely tradeable, equity sharing would flourish, and the wealth created by startup companies would be more widely shared. This would be good for our economy and our politics.