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STEIKER, FISCHER, EDWARDS & GREENAPPLE, P.C.

CLIENT ALERT

PROPOSED CHANGE IN TAXATION OF OPTIONS FOR S CORPS WITH ESOPs COULD HAVE FAR REACHING RAMIFICATIONS

Written by: Stephen P. Magowan

There is an important development in Washington of which all ESOP companies and companies thinking of adopting ESOPs must be aware. We also believe this is an issue on which all such companies and their employees must become engaged. Here is what is happening.

Proposed Change

On October 25, 2007, Representative Charles Rangel, Chair of the House Ways and Means Committee, introduced H.R. 3870. Though this is just the beginning of what will be a long process, Representative Rangel is perhaps the single most important Representative in Congress when it comes to bills relating to taxes.

The stated goal of H.R. 3870 is "to provide additional tax relief to low and moderate income individuals, to repeal the individual alternative minimum tax, [and] to reform the corporate income tax." Buried near the very end of this bill is a provision that will harm S corporation ESOPs by imposing severe tax consequences on S corporations with ESOPs that use options and warrants in compensation programs and in financing arrangements.

H.R. 3870 would create a new Code Section 409B called "Recognition of Ordinary Income on Sale or Exercise of Stock Option in S Corporation with an ESOP." (Apparently federal budget constraints are so great that they limit Congress's ability to use articles like "the" and to use the plural when necessary!)

What we do know, however, is that ESOPs - - and in particular S ESOPs - - are on the Congressional radar screen as a potential source of raising revenues.

Under Section 409B, if a person holds an option or warrant in an S corporation that also has adopted an ESOP, then when that person sells or exercises that option or warrant, he or she will have to recognize ordinary income as follows. When the holder exercises or sells the option, he or she would have to go back to the date that the option was granted and treat him or herself, from that date to the date of sale or exercise, as if he or she was a shareholder. Then, he or she would have to determine how much income or loss would have been allocated to his or her shares rather than to the ESOP shares if the option or warrant had been exercised on the date of grant.

Finally, the holder must (a) include this amount in taxable income in the year of the sale or exercise and (b) pay

interest on the taxes associated with this income at the underpayment penalty rate for each year he or she would have been allocated income pursuant to the deemed exercise.

Please note: These provisions are to apply only to options granted after the date of enactment of the law. Holders of existing options are not impacted by this law as drafted. Also, the income recognized under 409B is added to the holder's tax basis in the option. The impact of this, however, is essentially to convert capital gain for holders of incentive stock options and non-employment related options and warrants to ordinary income.

How might the numbers work roughly? Let's say you have an S corporation with 100 shares outstanding all of which are held by the ESOP. You own an option for 5 shares that you exercise in Year 2. In Year 1 when you were granted the option, the corporation has $100,000 of profit, all which is deemed allocated to the ESOP. If you had been a shareholder, only $95,238 would have been allocated to the ESOP (100/105 * $100,000). The difference of $4,762 will ultimately be allocated to you when you exercise the option and you will pay an interest charge on the tax on that amount. The $4,762 will be added to your basis in the option and decrease your gain on exercise, though it also may in essence convert capital gain to ordinary income. Plus you will pay tax on the difference between the exercise price of the option and the value of the stock on the date of exercise.

Larger Impacts of this Change

New Section 409B, if enacted in its current form, would apply to options, warrants, restricted stock, stock appreciation rights, phantom stock units, or any similar right to a future cash payment based on the value of such stock or appreciation in such value. Clearly, this section would penalize S corporation ESOP companies that want to use such rights as compensation tools. In addition, and perhaps even more gravely, warrants are frequently used in the financing of S corporation ESOP acquisitions. These provisions, if enacted, will drive up the costs of such financing.

Just the Beginning

This is just the opening salvo in what promises to be a long and drawn out Congressional process over tax reform. No one can predict what the ultimate product of such reform will be. What we do know, however, is that ESOPs - - and in particular S ESOPs - - are on the Congressional radar screen as a potential source of raising revenues.

We will be monitoring the situation closely. We will keep you informed and be active in the discussion in Washington and with Representative and Senators.

What You Should Be Doing

For several years now, the ESOP Association, the national lobbying organization for ESOPs, has been warning us that developments in Washington could be making ESOPs vulnerable to adverse legislative change. H.R. 3870 tells us that the wolf has arrived. In the struggle to come to grips with the federal budget deficit and the increasing reach of the alternative minimum tax, there will be winners and losers as Congress grapples with hard choices.

ESOP Association chapters around the country are starting a process with chapter members to make sure your local Representatives and Senators understand that ESOP employees are actual living, breathing – and voting – people. To make this work, our politicians must be brought in contact with those employees so that they can understand the ESOP connection to greater productivity, better benefits and better jobs rooted in the community. If you are not a member of the ESOP Association, we would urge that you consider joining now. If you are a member, we urge you to get involved in this work.

If you have questions about getting involved with your chapter, contact your chapter president or feel free to contact us and we will help you find the right person to talk with either here at SFEG or in your chapter.

IRS Extends Transition Relief For Deffered Compensation Plans

Written by: Robert W. Edwards

On October 22, 2007, the Treasury Department and the IRS published Notice 2007-86 extending through 2008 the time within which deferred compensation plans must be amended to comply with Section 409A of the Internal Revenue Code. Section 409A became effective January 1, 2005. Its broad reach extends beyond traditional deferred compensation plans and supplemental executive retirement plans to include severance benefits under employment agreements, executive bonus plans, long-term incentive plans, split dollar insurance arrangements, and even certain expense reimbursement arrangements. 409A contains strict rules on elections and distributions under covered deferred compensation plans and imposes substantial tax penalties on participants in deferred compensation plans that do not comply with 409A.

Effect of 409A on Stock Rights Plan. ESOP companies often provide equity based compensation for executives, in additional to coverage under their ESOP, including stock option, phantom stock and stock appreciation rights ("SAR") plans. 409A applies to some (but not all) stock rights plans. Phantom stock arrangements are **always** subject to 409A; qualified incentive stock options are **never** subject to 409A; nonqualified stock options and stock appreciation rights (SAR) plans **may** be subject to 409A. A nonqualified stock option or SAR plan generally will not be subject to 409A if it meets the following tests.

1. Options or SARs granted under the plan must relate to common stock (no dividend preferences are permitted) of the service recipient (employer) company.
2. The option price can never be less than the fair market value of the stock at the date of grant. In the case of a SAR, the payment cannot exceed the difference between the stock's fair market value at the date the SAR is exercised and its fair market value at the date of grant.
3. The option or SAR may not include any feature for the deferral of compensation (i.e., option shares must be delivered promptly upon exercise of the option, and SAR payments must be made promptly in a lump sum upon exercise of the SAR)

Transition Relief. During the transition period taxpayers can continue to change elections as to the form and timing of payments under deferred compensation plans without violating 409A. This relief is particularly useful for amending stock option and SAR grants so that they will not be subject to 409A. The transition relief allows changes to conform with the 409A requirements, provided that a change cannot 1) accelerate any payment into the year of election, or 2) defer into a later tax year amounts payable in the year of election. For example, a taxpayer could not in 2008 elect a distribution payable in 2008, or defer an amount otherwise due in 2008.

Good faith compliance required through 2008. For the remainder of 2007 and 2008, good faith compliance with 409A and prior guidance will generally be sufficient. However, a plan will not be deemed to be operating in good faith compliance if discretion is exercised in a manner that violates 409A. All plans must be amended to comply with 409A by January 1, 2009.

Correction Program. The Treasury and IRS expect to issue guidance shortly with respect to a correction program that will permit taxpayers to correct certain unintentional operational violations of 409A.

What To Do Now. If you haven't already identified and amended your deferred compensation plans subject to 409A, breathe a sigh of relief, but don't wait for long. Notice 2007-86 will be the last extension, and prompt action is recommended to ensure that your deferred compensation plans comply with 409A before benefits are paid out.

WHO IS NEW AT SFE&G AND SES ADVISORS?

Stephen P. Magowan

Steiker, Fischer, Edwards & Greenapple, P.C. is proud to announce the addition of Stephen P. Magowan as a Partner in charge of its new Burlington, Vermont office. Steve brings more than a dozen years of experience as an attorney and advisor to ESOP companies and trustees and will add new depth to the team of professionals here at SFE&G with his extensive experience in complex estate planning for business owners.

Prior to joining SFE&G, Steve was a partner with Gravel & Shea. Steve received his law degree in 1988 from Washington University in Saint Louis, Missouri.

He is a member of the Chittenden County, Vermont, and New York Bar Associations, as well as the American Bar Association where he sits on the Estate Planning and Estate Administration for Business Owners Committee.

Mr. Magowan lives in Burlington, Vermont with his wife and two children. Please welcome Steve by calling him at 802.860.4077 or by emailing him at smagowan@sfeglaw.com

Jane Rogers

SES Advisors is thrilled to announce the addition of Jane Rogers as a Senior Plan Administrator. Jane will provide professional ESOP administration and consulting services as well as assist in the marketing of SES Advisors' ESOP administration services.

Jane comes to SES Advisors from First Niagara Benefits. Prior to that she worked for Blue Ridge ESOP Associates, where she was the Director of Plan Administration. Jane has over 9 years of experience in ESOP administration.

Ms. Rogers will be located in Fairport, New York. Feel free to welcome her by calling 585.385.0819 or by emailing jrogers@sesadvisors.com.

Kyle Coltman

In spring 2007, Kyle Coltman joined SES Advisors as a Managing Director. Kyle will be responsible for feasibility assessment, deal structure and financing of ESOP transactions, resident in the firm's newly created West Coast office.

Kyle has over 27 years of experience in the field of ESOPs and has supervised several hundred ESOP buyouts for owners of privately-held companies. Prior to joining SES Advisors, Kyle was the CEO of Menke & Associates, the oldest ESOP advisory firm in the country.

Mr. Coltman graduated with honors from the University of California, San Diego, receiving a B.A. degree in Economics. He completed his M.B.A. degree in Finance at the University of California, Berkeley.

Mr. Coltman will be located in Palo Alto, California. Please welcome him to the firm by calling 650.617.3355 or by emailing kcoltman@sesadvisors.com.

Meg Shrum

SES Advisors is excited to welcome Meg Shrum as Senior Vice President. She will be involved in every aspect of our ESOP practice with emphasis on business development, feasibility analysis, deal structure and financing.

Meg comes to SES Advisors from the National Cooperative Bank, where she became one of the nation's most active and experienced ESOP lenders. Prior to joining NCB, Meg was a Managing Director with Riggs National Bank's Domestic Private Banking Division in Washington DC. She is a native to North Carolina and earned her MBA in entrepreneurship from the University of Arizona.

Ms. Shrum will be remaining in the DC area in our newly-formed satellite office in Lake Anna, Virginia. Feel free to welcome her by calling 540.872.4601 or by emailing mshrum@sesadvisors.com.