DESCRIPTION OF H.R. 5719, THE "EMPOWERING EMPLOYEES THROUGH STOCK OWNERSHIP ACT"

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Prepared by the Staff
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INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 5719, the "Empowering Employees Through Stock Ownership Act," on September 14, 2016. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

[1] This document may be cited as follows: Joint Committee on Taxation*, Description of H.R. 5719, the "Empowering Employees Through Stock Ownership Act"* (JCX-74-16), September 13, 2016. This document can also be found on the Joint Committee on Taxation website at www.jct.gov. All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

A. Treatment of Qualified Equity Grants

Present Law

Income tax treatment of employer stock transferred to an employee

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services.[2] These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction.

Under these rules, an employee generally must recognize income for the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the employee receives the stock, income is recognized for the taxable year in which received. If the employee's right to the stock is not substantially vested at the time of receipt, in general, income is recognized for the taxable year in which the employee's right becomes substantially vested.[3] The amount includible in the employee's income is the excess of the fair market value of the stock (at the time of receipt if substantially vested at that time or, if not, at the time of substantial vesting) over the amount, if any, paid by the employee for the stock.

In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.[4] An employee's right to stock or other property is transferable if the employee can transfer an interest in the property to any person other than the transferor of the property.[5] Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount

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[2] Sec. 83. Section 83 applies generally to transfers of any property, not just employer stock, in connection with the performance of services by any service provider, not just an employee. However, the proposal described herein applies only with respect to certain employer stock transferred to employees.

[3] Under section 83(b), if an employee's right to the stock is not substantially vested at the time of receipt (nonvested stock), the employee may nevertheless elect within 30 days of receipt to recognize income for the taxable year of receipt, referred to as a "section 83(b)" election. Under Treas. Reg. sec. 1.83-2, the employee makes an election by filing with the Internal Revenue Service a written statement that includes the fair market value of the property at the time of receipt and the amount (if any) paid for the property. The employee must also provide a copy of the statement to the employer.

[4] See section 83(c)(1) and Treas. Reg. sec. 1.83-3(c) for the definition of substantial risk of forfeiture.

[5] Treas. Reg. sec. 1.83-3(d). In addition, under section 83(c)(2), the right to stock is transferable only if any transferee's right to the stock would not be subject to a substantial risk of forfeiture.

included in the employee's income as a result of receipt of the stock.[6] The deduction is allowed for the employer's taxable year in which or with which ends the taxable year for which the amount is included in the employee's income.

These rules do not apply to the grant to an employee of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value.[7] Instead, these rules apply to the receipt of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on receipt, income recognition applies for the taxable year of receipt. If the right to the stock is not substantially vested on receipt, the timing of income inclusion is determined under the rules applicable to the receipt of nonvested stock. In either case, the amount includible in income by the employee is the excess of the fair market value of the stock as of the time of income inclusion, less the exercise price paid by the employee and the amount, if any, paid by the employee for the option. The employer's deduction is also determined under these rules.

In some cases, the transfer of employer stock to an employee may be in settlement of restricted stock units. Restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or in employer stock (or either). The receipt of employer stock in settlement of an RSU is subject to the same rules as other receipts of employer stock with respect to the timing and amount of income inclusion by the employee and the employer's deduction.

Employment taxes and reporting

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act ("FICA"), tax under the Federal Unemployment Tax Act ("FUTA"), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[8] Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. The tax imposed on the employer and on the employee is

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[6] Sec. 83(h).

[7] See section 83(e)(3) and Treas. Reg. sec. 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

[8] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act ("RRTA"), sections 3201-3241, to taxes equivalent to FICA taxes with respect to compensation as defined for RRTA purposes. Sections 3501-3510 provide additional rules relating to all these taxes.

each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the OASDI wage base ($118,500 for 2016); and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages.[9] The employee portion of FICA tax generally must be withheld and remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.[10]

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of $7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the Internal Revenue Service ("IRS").[11] Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes.[12] In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on Form W-2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.[13]

Statutory options

Two types of statutory options apply with respect to employer stock: incentive stock options ("ISOs") and options provided under an employee stock purchase plan ("ESPP").[14] Stock received pursuant to a statutory option is subject to special rules, rather than the rules for

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[9] The employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[10] Under section 3501(b), employment taxes with respect to noncash fringe benefits are to be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary. Announcement 85-113, 1985-31 I.R.B. 31, provides guidance on the application of employment taxes with respect to noncash fringe benefits.

[11] Sec. 3402. Specific withholding rates apply in the case of supplemental wages.

[12] Secs. 6041 and 6051.

[13] Employers send Form W-2 information to the Social Security Administration, which records information relating to Social Security and Medicare and forwards the Form W-2 information to the IRS. Employees include a copy of Form W-2 with their income tax returns.

[14] Sections 421-424 govern statutory options.

nonqualified options, discussed above. No amount is includible in an employee's income on the grant or exercise of a statutory option.[15] In addition, no deduction is allowed to the employer with respect to the option or the stock transferred to an employee on exercise.

If a holding requirement is met with respect to the stock received on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted or one year after the date the option is exercised. If a disposition occurs before the end of the required holding periods (a "disqualifying disposition"), statutory option treatment no longer applies. Instead, the income realized on the disqualifying disposition, up to the amount of income that would have applied if the option had been a nonqualified option, is includible in income by the employee as compensation received in the taxable year in which the disposition occurs and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

Employment taxes do not apply with respect to the grant of a statutory option, the receipt of stock pursuant to the option, or a disqualifying disposition of the stock.[16]

Nonqualified deferred compensation

Compensation is generally includible in an employee's income when paid to the employee. However, in the case of a nonqualified deferred compensation plan,[17] unless the arrangement meets certain requirements, the amount of deferred compensation is includible in income for the taxable year when earned (or, if later, when not subject to a substantial risk of forfeiture) even if payment will not occur until a later year.[18] In general, under these requirements, the time when nonqualified deferred compensation will be paid must be specified at the time of deferral with limits on further deferral after the time for payment.

Nonqualified options on employer stock may be structured so as not to be considered nonqualified deferred compensation and thus not subject to these rules.[19] An arrangement

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[15] Under section 56(b)(3), this income tax treatment with respect to stock received on exercise of an ISO does not apply for purposes of the alternative minimum tax under section 55.

[16] Secs. 3121(a)(22), 3306(b)(19), and the last sentence of section 421(b).

[17] Compensation earned by an employee is generally paid to the employee shortly after being earned. However, in some cases, payment is deferred to a later period, referred to as "deferred compensation." Deferred compensation may be provided through a plan that receives tax-favored treatment, such as a qualified retirement plan under section 401(a). Deferred compensation provided through a plan that is not eligible for tax-favored treatment is referred to as "nonqualified" deferred compensation.

[18] Section 409A and the regulations thereunder provide rules for nonqualified deferred compensation.

[19] Treas. Reg. sec. 1.409A-1(b)(5). In addition, statutory option arrangements are not nonqualified deferred compensation arrangements.

providing RSUs is considered a nonqualified deferred compensation plan and is subject to these rules, including the limits on further deferral of the amount due in settlement of an RSU.

Description of Proposal

In general

The proposal allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer.[20] An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested.[21] Absent an inclusion deferral election under the proposal, the income is includable for the taxable year in which the qualified employee's right to the qualified stock is substantially vested under present law.

If an employee elects to defer income inclusion, the income must be included for the taxable year that includes the earliest of (1) the date the qualified stock is sold, exchanged or otherwise disposed of; (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) the date seven years after the date the employee's right to the stock becomes substantially vested; and (5) the date the employee elects to include the amount in income. The amount included in income is the same amount that, but for the election, would have been included in income for the taxable year in which the employee's right to the stock became substantially vested.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option. In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply. In addition, the receipt of qualified stock by an employee is not treated as a nonqualified deferred compensation plan solely because of an inclusion deferral election under the proposal.

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income as described in (1)-(5) above.

[20] The proposal does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election.

[21] As in the case of a section 83(b) election under present law, the employee must provide a copy of the election to the employer.

Qualified employee and qualified stock

Under the proposal, a qualified employee means an individual who is not an excluded employee and who agrees to meet requirements necessary (as determined by the Secretary of the Treasury) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who is, or has been at any prior time, a one-percent owner of the corporation,[22] (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2),[23] or (4) who is, or has been for any prior taxable year, one of the four highest compensated officers of the corporation.[24]

Qualified stock is any stock of a corporation if--

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the right to receive the stock (that is, the option or RSU) was provided by the corporation to the employee in connection with the performance of services and the employee received the right in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock with respect to which, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to the corporation or otherwise receive cash in lieu of stock from the corporation.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the corporation is readily tradable on an established securities market during the calendar year or any preceding calendar year,[25] and (2) the corporation has a written plan under which, for the calendar year, not less than 80 percent of the corporation's employees receive stock options or

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[22] One-percent owner status is determined under the top-heavy rules for qualified retirement plans, that is, section 416(i)(1)(B)(ii).

[23] In the case of one-percent owners, this results from application of the attribution rules of section 318 under section 416(i)(1)(B)(i)(II). Family members are determined under section 318(a)(1) and generally include an individual's spouse, children, grandchildren and parents.

[24] This status is determined on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934 as if those rules applied to the corporation.

[25] This requirement continues to apply up to the time an inclusion deferral election is made. That is, under the proposal, no inclusion deferral election may be made with respect to qualified stock if any stock of the corporation is readily tradable on an established securities market at any time before the election is made.

RSUs with the same rights and privileges to receive qualified stock.[26] For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules.[27] However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount (provided that the number of shares available to each employee is more than a de minimis amount). In addition, the right to receive qualified stock pursuant to a stock option is not treated as the same right or privilege as the right to receive qualified stock pursuant to an RSU.[28]

For purposes of the proposal, corporations that are members of the same controlled group are treated as one corporation.

Notice, withholding and reporting requirements

Under the proposal, a corporation that transfers qualified stock to an employee must notify the employee that (1) the employee may elect to defer income inclusion with respect to the stock, and (2) if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock is substantially vested, notwithstanding whether the value of the stock has declined during the deferral period. Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The proposal includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers.[29] In addition, the employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee.

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[26] In applying the requirement that 80 percent of employees receive stock options or RSUs, excluded employees and part-time employees are not taken into account. For this purpose, part-time employee is defined as under section 4980E(d)(4), that is, an employee customarily employed for fewer than 30 hours per week.

[27] Sec. 423(b)(5).

[28] Under a transition rule, in the case of a calendar year beginning before January 1, 2017, the requirement that 80 percent of employees receive stock options or RSUs is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.

[29] That is, the maximum rate of tax in effect for the year under section 1.

Effective Date

The proposal generally applies with respect to qualified stock, an employee's right to which is not substantially vested before January 1, 2017. The penalty for a failure to provide the notice required under the proposal applies to failures after December 31, 2016.

B. Estimated Revenue Effect

Fiscal Years [Millions of Dollars]											
2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2017-21**	**2017-26**
-127	-176	-192	-198	-187	-158	-117	-77	-57	-33	-880	-1,321

NOTE: Details do not add to totals due to rounding.