A recent change in financial accounting standards has resulted in questions regarding the U.S. income tax withholding rules applicable to equity compensation. As background, in March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, to simplify accounting for equity grants to employees. Prior to ASU 2016-09, in order to avoid unfavorable liability accounting for equity compensation, net share settlement of an equity award was required to be limited to a number of withheld shares having a value that did not exceed the applicable "minimum statutory withholding" obligations. Under ASU 2016-09, FASB allows favorable financial accounting treatment for equity awards if the number of shares that are withheld pursuant to net share settlement (and the taxes paid in cash) does not exceed a number of shares having a value equal to tax withholding obligations calculated using rates of up to the "maximum statutory tax rates in the applicable jurisdiction." ASU 2016-09 generally is effective for 2017 for calendar-year public companies, although early adoption is permitted.
statutory rate applicable in the U.S. and is that rate permitted to be used for federal income tax withholding purposes?\(^1\) And, second, once the maximum rate and appropriate withholding are determined, does the plan and the grant documentation permit use of such withholding rates? Some employers have been under the impression that employees can now simply request withholding on equity compensation at the highest marginal individual income tax rate, which currently is 39.6%.\(^2\) However, this may not be as simple as it appears since detailed rules and regulations, as well as plan provisions, may limit the withholding options, as discussed below.

**U.S. Tax Rates and Applicable Withholding Rules**

The U.S. income tax withholding regulations distinguish between two types of wages for income tax withholding purposes—regular wages and supplemental wages. Under Reg. 31.3402(g)-1(a)(1)(ii), regular wages are "amounts that are paid at a regular hourly, daily, or similar periodic rate ... for the current payroll period or at a predetermined fixed determinable amount for the current payroll period." For regular wages, there are a number of permissible methods of withholding federal income taxes, but they all rely on receipt of a valid Form W-4 withholding exemption certificate from the employee (or, in the absence of such a Form W-4, withholding as if the employee were single, with no exemptions).

By contrast, special withholding rules apply to supplemental wages, which are defined as "all wages paid by an employer that are not regular wages."\(^3\) The supplemental wage withholding regulations make clear that the following forms of income are supplemental wages: nonqualified deferred compensation, income on exercise of a non-statutory stock option, and wage income recognized on the lapse of a restriction on restricted property transferred from an employer to an employee. Thus, the standard forms of equity compensation, including restricted stock units, are treated as supplemental wages for income tax withholding purposes.

The IRS takes the position that there are only three ways to withhold on supplemental wages: the mandatory withholding rate, the optional flat withholding rate, and the aggregate method.\(^4\) If supplemental wages paid to an employee exceed $1 million during the calendar year, the employer

\(^1\) ASU 2016-09 allows net share settlement to be calculated based on the maximum statutory rates in the employees' applicable jurisdiction, including federal, state, and local income taxes, as well as FICA and other payroll taxes. However, the following discussion will be limited to the federal income tax component of the maximum statutory tax obligations.

\(^2\) President elect Trump's proposed tax plan would change the current seven individual tax brackets to three, with the maximum individual income tax rate equal to 33%. The lower rates would be 12% and 25%. For purposes of this article, we assume the tax rates remain as they are under the current Code unless and until the Code is amended.

\(^3\) Reg. 31.3402(g)-1(a)(1)(ii).

is required to withhold from the supplemental wages over $1 million at the highest income tax rate for the tax year—39.6% for 2016. In the case of a supplemental wage payment that brings the total supplemental wages for a year over $1 million, the employer can choose to apply the mandatory supplemental rate to the entire payment or to just that portion of the payment in excess of the $1 million in supplemental wages.\(^5\)

For supplemental wages below $1 million, there are two permissible methods of income tax withholding and the employer has the choice of which to use. First, an employer can choose to use the optional flat rate. The optional flat rate allows the employer to use a flat 25% income tax withholding rate\(^6\) on the supplemental income, ignoring the employee's W-4 withholding allowances used for withholding on the employee's regular wages. The optional flat rate is available only if (1) the employer withheld income tax from the employee's regular wages in the current or previous year and (2) the supplemental wages are paid separately from regular wages or are paid concurrently with the regular wages, but separately identified.\(^7\) This optional flat rate method is frequently used. It tends to be easier for employers because of its simplicity and its ability to be used uniformly for all employees who do not have supplemental wages in excess of $1 million.

The other method that can be used for supplemental wages that do not exceed $1 million in a year is the aggregate method. The employer must use this method if the conditions for the optional flat rate are not present because, for example, the employer did not withhold income tax from the employee's regular wages.\(^8\) Using the aggregate method, the employer

\(^5\) Reg. 31.3402(g)-1(a)(4)(iv). According to the preamble to the regulation, TD 9276 (July 24, 2006), this decision as to how to treat the payment that brings an employee's supplemental wages over the $1 million mark can be "on an employee-by-employee basis."

\(^6\) The 25% rate is set forth in the regulations at Reg. 31.3402(g)-1(a)(7)(iii)(F). The regulation states that the optional supplemental rate for wages paid after 2004 is 28% "or the corresponding rate in effect under section 1(i)(2)." Since the Economic Growth and Tax Relief Reconciliation Act of 2001, the optional supplemental rate has been required to track the "third lowest rate of tax applicable under section 1(c)." See discussion in the preamble to the proposed supplemental withholding regulations at 70 Fed. Reg. 768-769 (Jan. 5, 2005). When rates were reduced in the Jobs and Growth Tax Relief Reconciliation Act of 2003, so that the third lowest rate became 25%, the optional flat rate for supplemental wages became 25%. It is unclear how this "third lowest rate" standard will apply if the rates are changed to a three-rate structure, with rates of 12%, 25%, and 33%. Presumably, the Service will issue a notice or other informal guidance telling employers what to do in that case. Another issue arises if legislation reducing rates is passed mid-year, and the rate changes are effective for the entire year. In that case, employers making payments before the rate reductions are enacted will have to withhold at the rates currently in effect when the payments are made unless guidance issued by the Service in anticipation of the rate increases provides otherwise.

\(^7\) Reg. 31.3402(g)-1(a)(7).

\(^8\) An employee can claim exemption from income tax withholding on his or her Form W-4. The conditions for claiming no income tax withholding on the Form W-4 are that the employee incurred no liability for income tax for the preceding year and anticipates he will incur no liability for income tax in the current year. Reg. 31.3402(n)-1(a). In the event an employer receives such a Form W-4 claiming no income tax withholding, according to the supplemental withholding regulations, the optional flat rate cannot be used for supplemental wage payments, presumably because use of the optional flat
will calculate withholding by aggregating the regular and supplemental wages as if they were a single payment for the current or most recent payroll period. The employer will then use the employee’s existing Forms W-4 to determine the withholding rate for the aggregate amount.

With the recently issued ASU 2016-09, employers and employees alike are wondering if withholding on supplemental income at the statutory maximum income tax rate is possible. Outside of the mandatory withholding requirement of Reg. 31.3402(g)-1(a)(2) for supplemental wages over $1 million, a 39.6% withholding rate is not expressly permitted. Form W-4 does not allow employees to withhold at specific rates; it only allows employees to specify dollar amounts to be withheld or identify the number of exemptions to be taken into account.\(^9\)

Though there is nothing in the regulations supporting an employee’s ability to ask the employer to withhold at the maximum rate, an employee can file a revised Form W-4 prior to a supplement wage distribution. This possibility is discussed in IRS Information Letter 12-0063. Once an employee submits a revised Form W-4, the employer must withhold pursuant to the new Form W-4 at the beginning of the first payroll period ending on or after the 30th day after which the W-4 was submitted. However, an employer may elect to use the new Form W-4 immediately. Thus, in order to increase withholdings to approximate the maximum rate, an employee could submit a revised W-4 prior to a supplemental wage payment to request an additional dollar amount of withholding and/or to claim reduced exemptions and then revise his or her Form W-4 again after the supplemental wage payment. However, the employer is not required to withhold from supplemental wages using the aggregate method based on the Form W-4. The employer can instead choose to ignore the Form W-4 and use the optional flat rate (25% rate) method.

As discussed, if the mandatory withholding rate for supplemental wages over $1 million is not required to be used, the employer has the choice to use the aggregate withholding method or the 25% optional flat rate withholding. Notwithstanding that this is the employer’s choice and that the 25% optional flat rate generally is administratively easier to use, now that ASC 718 allows equity financial treatment for withholding on up to the maximum rate, many employers are considering accommodating employee requests to withhold at a higher rate, based on the Form W-4, and allowing new Forms W-4 to be provided in connection with supplemental payments. However, an employer using such a mechanism to increase withholdings on supplemental wage payments could easily make administrative mistakes and fail to timely apply the Forms W-4, and

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\(^9\) Reg. 31.3402(l)-2 allows an employee to "request … that the employer deduct and withhold an additional amount from the employee's wages" by so requesting on the Form W-4.
thereby create (rather than solve) employee relations issues regarding the amount of income tax withholding.

While there is no penalty that is clearly applicable if an employer were to withhold at the maximum statutory rate outside the W-4 process, the Service has for many years strenuously objected to the use of any such informal “work around” to avoid the strictly applicable federal income tax withholding regimes. In Information Letter 12-0063, the Service considered the issue and stated that “if … an employer elects to use optional flat rate withholding, rather than the aggregate procedure, the prescribed optional flat rate must be applied, no deviation from that rate is permitted, and employee requests for additional withholding have no effect.” One objection from the Service to informal requests for higher withholding has been that such “work arounds” are a means of avoiding the estimated tax system. However, for many companies, equity compensation is granted and then vests and becomes taxable in the first quarter of the year. It is hard to see how an increase in withholding early in the year helps the employee avoid the estimated tax system.10

Given the current income tax withholding regulations, the only clear way to withhold at greater than the 25% optional flat rate on supplemental wages that do not exceed $1 million would appear to be the use of Forms W-4 and the aggregate method. However, having the employee submit several Forms W-4 over the course of a year and, using those Forms W-4 to withhold on supplemental wages, is administratively burdensome to the employer, and could result in mistakes in federal income tax withholding that defeat the purpose of trying to accommodate employee requests for a method of obtaining additional withholding. Where an employee is truly subject to tax at rates higher than 25%, it is hard to understand why the Service so adamantly disapproves of more streamlined methods of allowing a higher withholding rate on supplemental wages. It may simply be that the Service does not feel comfortable allowing withholding methodologies that are not set forth in the regulations. However, the Service has the ability to amend its regulations and allow employers greater flexibility in terms of withholding at higher rates on supplemental wage payments below $1 million. The Service has recently informally indicated some receptivity to amending its regulations to allow such increased flexibility. Employers that would be interested in having a more streamlined method of withholding at a higher rate on supplemental wages should consider what kinds of methods would work best and ask the Service to amend its regulations to allow such methods.

Need to Amend Plan Terms and Grant Documents

Whether or not the Service ever develops such a streamlined method for withholding on supplemental wage payments at higher rates, employers

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10 Under Section 6654(g), income tax withholding is treated as going in ratably over the course of the year for estimated tax purposes. Accordingly, large year-end withholdings could be viewed as a means of end running the estimated tax system.
who would like to withhold at a rate higher than the minimum withholding rate (through use of the aggregate method and Forms W-4) should consider whether they can do so under their plan and grant documents. Prior to ASU 2016-09, since liability financial accounting treatment would apply if plans were permitted to withhold at a higher rate, most plans expressly limited withholding to the minimum rate. Plan terms and grant documents may need to be amended to allow employers to withhold shares at a rate higher than the minimum withholding tax rate. Under both the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) listing rules, a material amendment to an equity compensation plan requires shareholder approval. One issue that had arisen was whether such a change to allow withholding shares at a higher rate would be considered a material amendment that would give rise to shareholder approval. Until recently, the NYSE and the Nasdaq had differing views on whether a company must get shareholder approval to amend its plans to allow for share withholding at higher than the minimum statutory rate.

The NYSE, through FAQs released on August 18, 2016, stated that amending a plan to withhold shares at the statutory maximum is not a material revision and, thus, does not require shareholder approval. Specifically, the NYSE stated in FAQ C-1 that “an amendment to a plan to provide for the withholding of shares based on an award recipient's maximum tax obligation rather than the statutory minimum rate is not a material revision if the withheld shares are never issued, even if the withheld shares are added back to the plan.” By contrast, unlike the NYSE, the Nasdaq originally indicated in informal telephone advice that shareholder approval would be required for an amendment to an equity compensation plan allowing net share withholding to satisfy tax withholding obligations at the maximum rate where the plan provides for recycling of shares used to satisfy tax withholding obligations. The Nasdaq’s theory for its original position was that such an amendment would result in the granting of additional awards under the plan due to the recycling of the shares held back to satisfy the tax withholding obligations. However, on October 19, 2016, the Nasdaq reversed its stance with the issuance of an FAQ concluding that “generally an amendment to an equity compensation plan to increase the withholding rate to satisfy tax obligations would not be considered a material amendment to the plan.” Thus, the Nasdaq now generally shares the view of the NYSE that shareholder approval of such an amendment is not required even where the plan provides for a recycling of shares to satisfy the tax withholding obligations.

However, the relief provided under the NYSE guidance may be considered to be more restrictive than the relief provided by the Nasdaq. The NYSE appears to limit amendments allowing net share withholding to be calculated based on the employees’ maximum tax obligations rather than on the maximum statutory tax rate applicable in a given jurisdiction, as permitted under ASU 2016-09. ASU 2016-09 notes that
the number of shares that may be withheld is not limited to the highest rates paid by the specific award grantee. Instead, it is limited to the maximum tax rates in the applicable jurisdictions. For example, an employer could withhold a number of shares having an aggregate fair market value equal to the maximum federal income tax rate, plus state and local income taxes even if that maximum rate is more than the highest rate payable by the specific employee. Unlike the NYSE guidance, the Nasdaq allows amendments to a stock plan to increase the withholding rate to satisfy tax obligations without specifying that the withholding rate must be capped at the specific employee’s actual tax rate. The limitation imposed under the NYSE rules may not make a practical difference in the U.S. given the current income tax withholding regulations described above (i.e., withholding at the supplemental rate or W-4 rate). However, it may be appealing in jurisdictions outside of the U.S. to be able to withhold at a single rate using the maximum statutory rate in the applicable jurisdiction as permitted under ASU 2016-09. Thus, even though companies whose shares are listed under both major exchanges can now make changes to their plans and grant documents allowing higher rates of income tax withholding without the need for shareholder approval, companies that are listed on the NYSE may need to consider whether they would be permitted to amend their plans to allow withholding at the maximum tax rates in the applicable jurisdiction without seeking shareholder approval in light of the ostensibly less generous relief provided under NYSE guidance.