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Employment Tax Considerations for Equity Plans as T+2 Settlement Cycle Rule Takes Effect

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On March 22, 2017, the Securities and Exchange Commission ("SEC") adopted an amendment to its securities transaction settlement rule to shorten the standard settlement cycle for most broker-dealer securities transactions from three business days after the trade date (T+3) to two business days (T+2).[1] The new settlement cycle rule takes effect on September 5, 2017, and is lauded by the SEC as a change that "will increase efficiency and reduce risk for market participants."[2] Although that is likely true, the change hits close to home for U.S. public companies maintaining equity compensation plans, many of which are spending the summer ramping up their equity award administration systems in preparation for the day (right after Labor Day weekend) when they will have one day less in which to settle equity plan transactions that involve a sale on the market. A question that frequently comes up is the impact of the new settlement cycle on the timing of tax withholding and deposit of taxes with the IRS. In this column, we address this issue and other related equity award administration, tax withholding, and tax calculation topics, with a particular focus on stock options and restricted stock units ("RSUs").

T+2 and Equity Plan Transactions

For public companies operating equity compensation plans, the shortened settlement rule will primarily affect stock option exercise transactions conducted through a broker-assisted "cashless" procedure. Under a cashless option exercise, the optionee instructs a broker to immediately sell all or a portion of the shares issued upon exercise of the option, use the sale proceeds to pay the option strike price plus brokerage fees and any applicable withholding taxes, and remit the balance to the employee in cash, or net shares, as applicable. Because the optionee has an unconditional right to receive the stock upon exercise of the option, the IRS takes the position that the employee's exercise of the option triggers taxation under Section 83(a), even though the employee does not actually receive the shares (or cash proceeds) for several days after exercise. The IRS also takes the position that the spread income on option exercise must be treated as wages at that time.[3] The introduction of T+2 means that companies will need to administer these broker-assisted option exercise transactions significantly more quickly, including calculating the amount of withholding taxes and delivering shares to the broker in time to enable the broker to deliver the net shares or cash proceeds to the optionee by the second business day after the exercise date.

With regard to calculating taxes, for U.S. plan participants, it is not normally difficult to calculate the amount of income tax withholdings due in connection with an option exercise because income from stock options is considered supplemental wages, for which a flat withholding rate may be used. In this regard, the employment tax regulations permit employers to determine the tax to be withheld from supplemental wages using a flat rate of (currently) 25%, without taking into consideration the amount of regular wages or the withholding allowances claimed on the employee's Form W-4, Employee's Withholding Allowance Certificate.[4] If the option exercise spread, when added to all supplemental wage payments previously made by the employer to an employee during the calendar year, exceeds $1 million, withholding on the excess amount must be applied at the highest marginal tax rate (currently 39.6%), without regard to the employee's Form W-4.[5] Notwithstanding the relative simplicity of withholding federal income taxes at the supplemental rate, there remain other complexities in withholding from equity compensation. For example, the FICA tax withholding will depend on how much in other wages the employee has received and whether the employee has otherwise met the social security wage base ($127,200 for 2017). If the employer's wages are over the wage base, social security taxes will not apply, and only Medicare and additional Medicare taxes are applicable. Additionally, withholding on equity compensation can be difficult due to the need to coordinate between a number of parties, including the payroll processor and the broker that administers the equity plan. There are also issues having to do with the price used to value the stock transferred on exercise. Due to the need to feed payroll information into the payroll system in advance, it generally is necessary to use a valuation mechanism that looks back to a period before the date the stock is credited to the employee's account. Further complications are created if employees move between states or countries during the vesting of the equity compensation. Therefore, companies with a large number of non-U.S. equity plan participants or mobile participants who have worked in several countries and/or states during the life of an option may face challenges in implementing the shortened settlement period, given the potential difficulty with rapidly calculating withholding taxes when non-U.S. and/or multi-jurisdictional tax rules and rates have to be considered and income has to be sourced to different jurisdictions.

On top of this, companies must bear in mind the IRS's next-day deposit rule, which requires the deposit of employment taxes with the IRS within one business day when an employer accumulates $100,000 or more of employment taxes at any one point (including withheld income and FICA taxes).[6] For many years there was a dispute between the IRS and companies offering options to employees regarding the timing of payroll tax withholding and deposits, which resulted in the IRS proposing to assess significant deposit penalties. The IRS took the position in audits that the withholding obligation occurs at exercise, the same time at which the income recognition occurs under Section 83. Taxpayers, instead, took the position that the wage withholding obligation arises only when the stock is paid to the employees, i.e., when it is credited to the employee's account several days later. In 2003, after companies and their trade groups exerted significant pressure, the IRS issued a Field Directive which instructed IRS auditors not to challenge the timeliness of deposits made within one day of settlement, if the settlement occurred within three days of option exercise (the "2003 Field Directive")[7]. The IRS explained its position in the 2003 Field Directive as follows:

> There is presently no specific published guidance relative to whether the date of exercise or date of settlement is the appropriate date for considering assertion of the penalty for failure to deposit employment taxes attributable to the exercise of nonqualified stock options. Until such time as guidance is issued or this Field Directive is modified or revoked, LMSB Employment Tax Specialists should not challenge the timeliness of deposits required under Treas. Reg. § 31. 6302-1(c), if such deposits are made within one day of the settlement date, as long as such settlement date does not fall more than three days from the date of exercise.[8]

Although the IRS has not issued any updated guidance on its position, with the implementation of the new T+2 settlement rule, the next-day deposit rule should mean a corresponding reduction of the deposit deadline for taxes relating to such exercises to T+3 (assuming $100,000 of accumulated employment taxes). Therefore, companies should be prepared to calculate tax withholdings on broker-assisted option exercises and settle the transaction within two business days from exercise and then, to the extent the accumulated employment taxes exceed $100,000, deposit the taxes with the IRS by the third business day after exercise.

What If There Is No Updated Guidance from the IRS?

Another question that arises in connection with the move to T+2 is whether the 2003 Field Directive remains valid and what happens if it is not updated by the IRS? Is there a risk that the IRS would revert to the position in the early 2000s, when it maintained that employers subject to the $100,000 next-day deposit rule must deposit the employment taxes associated with nonqualified option exercises the day after the employee instructs the broker to exercise the option?

Most practitioners would tell you that this is highly unlikely, and indeed for stock options this is probably true. Even if the IRS does not issue additional guidance, the 2003 Field Directive itself supports the position that a deposit of taxes accumulated with respect to an option exercise will be deemed timely if deposited "within one day of settlement," whether that occurs three business days or two following the exercise date, on the basis that the optionee does not have actual or constructive receipt of the relevant option wages until the settlement date.

Restricted Stock Unit Considerations

The Field Directive has never applied by its terms to RSUs, but the same principles should apply. Notwithstanding that IRS agents have in the past asserted that employment tax deposits should be made the day after an RSU vests, the right answer is that it is only when the RSU is settled by a payment of stock or cash that the wage withholding obligation arises. Accordingly, the deposit obligation in the case of an accumulation of $100,000 in employment taxes should arise only on the day after the payment of the wages, i.e., on the day after the transfer of shares and crediting of the shares to the employee's account.

As background, an RSU is an equity compensation arrangement that begins its life as an unfunded and unsecured promise that the employee will receive shares in the future upon satisfaction of certain vesting conditions, normally including continued employment and/or achievement of performance goals. The employee has no rights as a shareholder until the vesting conditions are met and the shares are issued to the employee.[9] Unlike with stock options, typically no purchase price is payable for the shares issuable upon vesting of the RSUs.

From a tax perspective, the grant of an RSU does not constitute the transfer of property for purposes of Section 83.[10] Instead, RSUs are taxable under principles of actual or constructive receipt. Upon the vesting of RSUs, the employee's right to receive the underlying stock is no longer subject to a substantial risk of forfeiture, but the employee does not receive the shares and does not have any rights as a shareholder until the shares are deposited into an account on behalf of the employee. The transfer of shares to an employee following vesting of an RSU is a Section 83 event, with the result that taxation applies upon such transfer.[11]

With RSUs, the wages are properly viewed as paid when the employer transfers the shares and the shares are credited to the employee's account. At this time, taxes should be withheld, and then, if the accumulated employment taxes equal $100,000, those taxes should be deposited the next day. There is no income event or wage payment ahead of the stock transfer. Not only is the taxable event of the RSUs upon delivery of the shares to the employee and not upon vesting (as outlined above), but also the plain language of the Code and the applicable regulations provide that employment taxes are collected when the employer pays the employee. Specifically, Section 3101 imposes the FICA tax on employee wages to fund the Social Security and Medicare programs and Section 3102(a), relating to "Deduction of tax from wages," states that "[t]he tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages *as and when paid*." (Emphasis added.) Although RSUs are considered as nonqualified deferred compensation and subject to a special timing rule under Section 3121(v) which results in FICA tax applying at vesting, Treas. Reg. § 3121(v)(2)-1(e)(5) allows employers to rely on a rule of "administrative convenience" to use any date on or after the vesting of an RSU and prior to the end of the applicable tax year to take the value of the vested award into account for FICA tax and wage withholding purposes. Therefore, where RSUs are settled on or shortly after the vesting date, it is acceptable and typical for employers to take RSUs into account for both FICA and income tax purposes on the same date when the shares are delivered, in which case the withholding and deposit deadlines for FICA and income tax would be aligned.

Similarly, Section 3402 requires employers to deduct and withhold income tax from wages paid to employees. Section 3402(a)(1) provides that such withholding is determined in accordance with computational procedures prescribed by the Secretary. Reg. 31.3402(a)-1(b) states that "the employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages *as and when paid, either actively or constructively.*" (Emphasis added.) With respect to constructive payment, the regulation specifies that "wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not then actually reduced to possession. To constitute payment in such a case, the wages must be credited to or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that they may be drawn upon at any time, and their payment brought within his own control and disposition."[12]

As applied to RSU administration, at the time of vesting of RSUs, there is no "actual" payment because there is no actual transfer of property. There is also no "constructive" payment at vesting because before shares can be credited to an employee's account, the RSU award must be converted to stock and the company (usually) must calculate the appropriate number of shares to withhold or sell to cover tax withholdings, a process which typically takes one to three business days. Until the time that an awardee receives the shares in his or her individual broker account, the awardee may not control, draw upon, or dispose of the shares and has no rights as a shareholder. Therefore, actual and constructive payment occurs only when RSU shares are transferred into the brokerage accounts of individual awardees and a proper application of the above provisions of the Code and the regulations results in an obligation to withhold FICA taxes and income taxes only as of such date, i.e., "as and when [such shares are] paid."[13] Only then do RSU shares constitute a form of "remuneration" for purposes of the statutory and regulatory withholding obligations. And only then does the obligation to collect the employment taxes arise. As a result, where employment taxes are collected at the time the broker deposits the shares into the brokerage accounts of individual awardees, companies will satisfy the requirement to collect the employment taxes with respect to RSUs.

In terms of the deposit rules, an employer does not generally accumulate employment taxes for purposes of depositing those taxes until the wages are paid and the withholding taxes are withheld from the wage payment.[14] The IRS's administrative guidance makes clear that equity compensation is not treated as wages until "the date of crediting of such stock to the employee's account."[15] Therefore, the deadline for remittance of accumulated taxes to the IRS commences upon such payment date, and not upon the earlier vesting date of RSUs. Companies facing employment tax audits by the IRS should bear this in mind if the IRS seeks to assess next-day deposit penalties under Section 6656 based on a failure to remit accumulated employment taxes within one business day of vesting of RSUs.

Timing of Valuation for RSU Taxation

As outlined above, the taxable event for RSUs occurs following vesting when shares of stock are transferred to the awardee and the obligation to withhold taxes arises at the point the shares are deposited into the awardee's account. This being the case, it is worth addressing how the stock should be valued for purposes of calculating the amount subject to ordinary income taxation, on which tax withholding should be applied.

In this regard, in establishing that the medium in which property is paid is immaterial for purposes of determining whether it constitutes wages for purposes of withholding employment taxes, Reg. 1.3121(a)-1(e) provides that "remuneration paid in items other than cash shall be computed on the basis of the fair value of such items at the time of payment." Further, the IRS income tax withholding regulations also state that where wages are paid in property other than money, such as stocks, bonds, etc., the fair market value of the property given as remuneration is the measure of the wages subject to withholding.[16] The IRS has also ruled that if a corporation compensates an employee by giving him some of its own stock, the fair market value of the stock at the time of transfer is used as the basis of withholding.[17]

Based on the foregoing, as one might expect, the taxable value of vested RSUs and the amount subject to withholding should be calculated using the fair market value at the time of transfer of the shares. However, neither the Code nor the regulations specify a fixed rule that must be used to determine such fair market value. Instead, in various contexts, the regulations suggest that any reasonable method may be used to determine the fair market value, at least with respect to publicly traded stock.

For example, for purposes of setting the exercise price of an incentive stock option ("ISO"), which must be no less than the fair market value of the stock on the date of the grant of the ISO, Reg. 1.422-2(e)(1) states that the price "may be determined in any reasonable manner, including the valuation methods permitted under § 20.2031-2 of this chapter." Reg. 20.2031-2, in turn, provides that the fair market value for traded stock may be "the mean between the highest and lowest quoted selling prices on the valuation date."[18] Similarly, for purposes of Section 409A, which also requires the exercise price to be set no less than the fair market value of the stock on the date of grant, the regulations provide as follows (emphasis added):

> In the case of service recipient stock that is readily tradable on an established securities market, the fair market value of the stock may be determined based upon the last sale before or the first sale after the grant, the closing price on the trading day before or the trading day of the grant, the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, *or any other reasonable method using actual transactions in such stock as reported by such market.*[19]

These discussions of determining the fair market value of stock in the regulations help to show that the IRS allows an employer to use any reasonable valuation method to determine the value of publicly traded stock. Indeed, the above-cited Section 409A regulations go on to permit the use of an "average selling price during a specified period that is within 30 days before or 30 days after the applicable valuation date" in certain circumstances.[20] Therefore, in the context of a vested RSU award, where there is a short period between the date of vesting and the date on which shares are delivered (as is typical), it should be possible to determine the taxable value of the shares to be delivered pursuant to such vesting event using the closing price on the date of vesting, or on the prior or following trading day, or using any other reasonable method. Importantly, companies are not necessarily required to use the value of the shares on the date that they are delivered to the RSU holder, notwithstanding that such date is the date of the taxable event. This flexibility is crucial for purposes of equity plan administration because it would simply not be feasible to accomplish all of the actions required to process a vesting event (usually for large numbers of employees simultaneously and including calculation of tax withholdings) and deposit the shares in individual brokerage accounts in a single day, as would be necessary if the taxable value had to be determined using a trading price on the date the shares are delivered.

From a practical perspective, to support the reasonableness of any method used for valuing shares issued upon vesting of RSUs, companies should document their process and use it consistently. Also, to help head off disputes with RSU holders arising from movements in the stock price between the RSU vesting date and the share delivery date, companies may not want to go so far as to contractually bind themselves in plans or award agreements to using any particular valuation method, but should communicate to employees their ability to select an appropriate method, as well as the method they currently intend to use, such as via the equity plan prospectus.

Finally, for a typical RSU vesting event where shares are delivered shortly after vesting, it is acceptable (and very common) to use the closing price on the vesting date as the value of the shares for tax purposes. However, in situations where there is an unusually extended period between the vesting date and the share delivery date (e.g., where vesting is subject to a terminated employee's execution and non-revocation of a release), it may no longer be reasonable under the regulations cited above to use the scheduled vesting date value to calculate the fair market value of the shares delivered. Therefore, any documented process to be used for valuing shares relating to vested RSUs should build in an alternative valuation rule that will be applied consistently in situations where shares are not delivered upon or shortly following the vesting date.

Transition and Implementation of the New Settlement Cycle Rule

The change in the SEC's settlement cycle rule to T+2 will inevitably cause time-crunch issues for companies offering stock option plans, especially given that broker-assisted cashless exercises tend to be a prevalent form of exercise. Due to the need to calculate tax withholdings on such exercises on an accelerated basis, companies with a large number of non-U.S. option holders or mobile participants who have worked in several countries and/or states during the life of a stock option should consider the feasibility of moving to maximum rate or other single flat rate withholding per non-U.S. jurisdiction and should engage with any tax advisors assisting with mobile employees to confirm their ability to deliver tax calculations for multi-jurisdictional transactions within 24 hours of a transaction.

From a U.S. tax perspective, companies can expect the rationale of the IRS's 2003 Field Directive to remain valid and applicable, but this will mean that accumulated employment taxes of $100,000 or more relating to cashless option exercises will need to be deposited with the IRS by T+3, down from T+4 under the current settlement cycle rule. In view of the difficulty of adjusting option administrative processes following T+2's effective date on September 5, 2017, the IRS should consider applying leniency with respect to the imposition of failure to deposit penalties under Section 6656, at least for an interim period while companies fully implement the required new processes. For example, for a three to six-month transition period, the IRS could consider that failure to timely make next-day federal tax deposits due on cashless option exercises may be excused under Section 6656(a) due to "reasonable cause," at least in cases where companies have "exercised ordinary business care and prudence," as required by Reg. 301.6651-1(c)(1), but have missed the deadline because of adjustment to the new settlement cycle rule.

Meanwhile, although RSU plans are generally not directly impacted by the change in the settlement cycle rule, the change provides a good opportunity for focus on both the valuation of RSU shares for tax purposes and the timing of tax deposits relating to RSUs. In this regard, companies should feel comfortable using any reasonable method to determine the fair market value of shares issuable upon vesting of RSUs, provided that such method is used consistently and that the date as of which value is determined is proximate to the date on which shares are credited to the accounts of employees. In addition, similar to the position for options under the 2003 Field Directive, companies offering RSUs should not face failure to deposit penalties as long as they deposit employment taxes of $100,000 or more within one business day of the settlement of the RSUs through crediting of shares to an employee's account.

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[1] Rule 15c6-1(a) under the Securities Exchange Act of 1934.

[2] Statement by SEC Acting Chairman, Michael Piwowar, in SEC Press Release, "SEC Adopts T+2 Settlement Cycle for Securities Transactions," March 22, 2017.

[3] Reg. 1.83-7; Rev. Rul. 67-257, 1967-2 CB 359. As discussed further below, the issue of when the federal income tax and Federal Insurance Contributions Act ("FICA") withholding is required is not as clear as the IRS would like to suggest in its rulings.

[4] Reg. 31.3402(g)-1(a)(7).

[5] Reg. 31.3402(g)-1(a)(2). Alternatively, the employer can withhold at the 39.6% rate on the entire payment that brings the employee to $1 million in supplemental wages. Reg. 31.3402(g)-1(a)(4)(iv).

[6] Reg. 31. 6302-1(c)(3). Failure to make deposits as required by Section 6302 can result in penalties under Section 6656 of 2% if the failure is for not more than five days, 5% if the failure is for more than five days but not more than 15 days, and 10% if the failure is for more than 15 days.

[7] "Field Directive on Assertion of the Penalty for Failure to Deposit Employment Taxes," March 14, 2003, signed by Keith M. Jones, Director, Field Specialist, to the Large and Mid-Size Business ("LMSB") Division Industry Directors.

[8] *Id.*

[9] In this article, we are focusing on RSUs which are settled on or shortly after their vesting date, not deferred RSUs.

[10] Reg. 1.83-3(e) states that property does not include "an unfunded and unsecured promise to pay money or property in the future."

[11] For example, see Ltr. Rul. 8019053 (February 13, 1990), and IRS Notice 2009-85, 2009-45 IRB 598 (October 15, 1990) (defining Section 83 "property" to include a stock-settled RSU "to the extent that the compensation payable under such restricted stock unit is in the form of a transfer following the satisfaction of such vesting condition of shares of stock or other property"). See also IRS Equity (Stock)-Based Compensation Audit Techniques Guide (August 2015).

[12] Reg. 31.3402(a)-1(b).

[13] Section 3102(a) and Reg. 3121(v)(2)-1(e)(5); Reg. 31.3402(a)-1(b).

[14] Regs. 31.3402(a)-1(b) and 31.3121(a)-2 and 3121(v)(2)-1(e)(5).

[15] Rev. Rul. 78-185, 1978-1 CB 304; see also, Rev. Rul. 79-305, 1979-2 CB 350 (holding that in the case of restricted stock, withholding was not required until "the stock was made

available to the employee without any substantial limitation or restriction and was available to be used by the employee at any time").

[16] Reg. 31.3401(a)-1(a)(4).

[17] Rev Rul 58-269, 1958-1 CB 344.

[18] See also *Walter*, TC Memo 2007-2 (upholding employer's valuation based on the average of the high and low reported prices on the date of the option exercise).

[19] Reg. 1.409A-1(b)(5)(iv)(A).

[20] *Id.* Such average selling price is permitted where the program under which a stock right is granted irrevocably specifies the commitment to grant the stock right with an exercise price set using such an average selling price before the beginning of the specified period