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Deposits of Federal Employment Taxes for Equity Related Transactions—Pitfalls to Avoid

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Equity compensation is often paid or vests at a time other than the regular payroll date. IRS payroll deposit rules may require tax deposit dates for these "off-cycle" payments that are earlier than regularly scheduled payroll deposit dates; as a result, companies may miss the deadlines. This article describes the complexity of the deposit timing rules, cautions that employers could potentially face penalties if deadlines are missed, and lays out some ideas designed to comply with the rules and avoid these pitfalls.

Companies use equity-based compensation to attract, retain, and motivate employees. Unfortunately, companies may not realize that there are special rules for the deposit of "off-cycle" compensation, including equity-based compensation, and penalties for failing to satisfy those special timing rules. The IRS now appears to be looking for these mistakes and can collect significant penalties and interest for failure to timely deposit payroll taxes.

Even companies that use third party administrators have found that their payroll providers do not always know these rules, or do not realize that each employer needs to timely provide the information so the payroll company can accomplish the required withholding and depositing pursuant to the accelerated deposit rules.

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This article discusses the deposit timing for equity compensation and the penalties that can accrue for late equity compensation deposits. The same rules apply to other "off-cycle" payments (such as bonuses), but the focus of this article (and apparently of the IRS examinations) is equity compensation payroll deposits.

Timing of Equity Compensation Taxation

Awards of restricted stock, restricted stock units ("RSUs"), stock appreciation rights ("SARs"), and non-qualified stock options ("NQSOs") to employees eventually result in employee compensation being subject to federal payroll tax and thus trigger the payroll deposit.[1] The employer must withhold federal income tax from the equity compensation and withhold and deposit employer and employee Federal Insurance Contribution Act ("FICA") taxes, based on the gain realized as a result of the exercise or vesting of the equity compensation. The timing of taxation varies slightly based on the nature of the award.

Restricted stock subject to a substantial risk of forfeiture is transferred into the employee's name on the date of grant but is generally included in the employee's taxable income on the date that the substantial risks of forfeiture lapse (often called the vesting date). The employee has compensation equal to the fair market value ("FMV") of the shares on the actual date of vesting.

RSU plans are deferred compensation plans providing a later distribution of shares to the employee after the plan conditions are satisfied. The employee has compensation equal to the FMV of the shares on the date payment of the shares are initiated for distribution to the employee (not necessarily the vesting date). Stock settled SARs are under the same taxation rule and thus the employee has compensation equal to the FMV of the share on the date payment of the shares are initiated for distributed to the employee.

NQSOs allow the employee to acquire company shares through payment of an established exercise price, which is almost always the fair market value of the company stock at the date of grant. An employee has taxable compensation on the options on the date of the option exercise, on the "spread" between the FMV of the shares on the exercise date and the exercise price.

Timing of Deposits of Employment Taxes

Most large employers are required to deposit federal employment taxes on a semi-weekly basis. Specifically, employers in this category are required to deposit their federal employment taxes as follows:

Payments made on	Deposit on
Wednesday, Thursday, or Friday	Wednesday the following week
Saturday, Sunday, Monday, or Tuesday	The following Friday

[1] State payroll tax deposit rules may also apply, but these rules are not addressed in this article.

Examples of Payments	Deposit on
Payment on Wednesday, January 3	Wednesday, January 10
Payment on Saturday, January 6	Friday, January 12

Under these rules, if the deposit day falls on a non-business day (a business day is any day other than a Saturday, Sunday, or legal holiday), it will be considered timely if the deposit is made by the close of the next business day.[2]

However, employers also need to be aware of the "Next Day Deposit Rule."

Rules on Off-Cycle Payments and the $100,000 Next Day Deposit Exception

If, during a payroll period, an employer accumulates at least $100,000 in federal payroll taxes (FIT & FICA) that needs to be deposited, those deposits are due by close of business on the next business day rather than on the semi-weekly schedule (with one exception for nonqualified stock options, discussed below).[3] The $100,000 liability amount may be the result of regular wage payments, bonus payments, equity payments, or other forms of employee compensation.

> For example, assume a restricted share right vests on Tuesday, April 5, and the next payday is Friday, April 15. The employer cannot simply wait and deposit the restricted share payroll taxes with the other payroll taxes on April 15. Instead, the employer should determine whether the Next Day Deposit Rule or the regular semi-weekly rule applies to the off-cycle payment.
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> If the only off-cycle payment is a restricted share vesting with a FMV value of $20,000, the Next Day Rule does not apply and, using the semi-weekly charts above, the employer must deposit the payroll taxes on the restricted share on April 8 (Friday—see the chart above).
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> If the FMV of the restricted shares on the date of vesting is $400,000, the payroll taxes due are above $100,000, the Next Day Deposit Rule applies, and the deposit needs to be made the next business day, in this case, April 6 (Wednesday).

The $100,000 Next Day Deposit Rule applies to any off-cycle compensation, including bonuses, but is most often a problem for equity compensation because the payment dates may be less regular and may be unpredictable. If the payroll department does not immediately receive all the information about vesting, distribution, or exercise, or if a third party does not have all of the information needed, the company can easily miss the Next Day Deposit deadline.

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[2] Section 31.6302-1(c)(4). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[3] Section 31.6302-1(c)(3).

Equity "Settlement Rule"

The IRS provided via a 2003 field directive, a specific, narrow exception for liability recognized as a result of the exercise of NQSOs. In this directive the IRS indicated that agents should not challenge a three-day settlement period following the date of exercise of NQSOs, if the deposit is then made the next business day.[4] On IRS examinations, the IRS has acknowledged the difference and has accepted the extra three days for options but does not permit any extra time for other off-cycle payments that are due with respect to the Next Day Deposit Rule.

Following Generic Legal Advice Memorandum 2020-004, the IRS released a procedural update to the Internal Revenue Manual, which shortens the period of settlement to two days (likely in connection with the shortening of the SEC settlement period referenced in the field directive) and extended the administrative waiver to stock-settled SARs and RSUs.[5]

As an example, if a group of employees exercise their options on June 2, 2020 (a Tuesday) causing the employer to have a deposit obligation of $120,000, that withholding deposit will not be challenged as untimely if the deposit is made on June 5 (a Friday).[6] In this example:

- June 2 is the date of exercise
- June 4 is the date of settlement (two days from date of exercise)
- June 5 is the date of deposit

Late Deposit Penalties

IRS agents have become increasingly aware of the Next Day Deposit Rule, and in particular the impact on equity compensation and deferred compensation payments that are made "off-cycle."

Section 6656 failure to deposit penalties range from 2 to 10 percent depending on the number of calendar days that the deposit is late. Thus, if an employer accumulated $1 million in withholdings on February 10 but the deposit was not made until February 17, the deposit is considered late by seven calendar days (including the actual date of liability), which results in a five percent penalty, as further detailed below:

- 2 percent—1-5 days late
- 5 percent—6-15 days late

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[4] IRS Field Directive, March 14, 2003 Memorandum, *Assertion of the Penalty for Failure to Deposit Employment Taxes*.

[5] For more information, please see Robert Delgado, Terri Stecher, Kelli Cacciotti, *IRS Addresses T+2: Settlement Period for Stock Options (including RSU and SAR Considerations!)*, What's News in Tax (Aug. 10, 2020).

[6] For further discussion of the rules regarding Non-qualified Stock Option Compensation, see Gary Cvach, Carolyn Rhodes, and Steven Friedman, *Stock Option Compensation – Warnings for the Unwary*, What's News in Tax (Sept. 8, 2015).

- 10 percent—16 or more days late (also applies to amounts paid within 10 days of IRS first sending notice of payment due)
- 10 percent—amounts (which should have been deposited) paid directly to IRS or paid with return (excluding de minimis)
- 15 percent—amounts still unpaid after 10 days of first notice of payment due or the day the employer received notice and demand for immediate payment, whichever is earlier

IRS rules provide a special safe harbor if the amount of the late deposit is low. Within the “accuracy of deposits” rule, an employer that deposits less than 100 percent of its tax liability is not subject to penalties if the shortfall does not exceed $100 or two percent of the amount of tax that should have been deposited, and the shortfall is deposited by the shortfall makeup date.

There is a “reasonable cause” exception to the payroll deposit penalties but the IRS has not generally accepted a lack of awareness or an inadequate payroll system as reasonable cause for late deposits.

Planning Ahead

With the potential for significant penalties every time an employee group exercises NQSOs, when restricted shares vest, or when RSUs are distributed, there are a few ways in which employers can stay on top of equity compensation withholding deposits and reduce their overall risk in this area.

For equity compensation with flexible schedules (such as RSUs with a stated period of time after the vesting date during which distributions may be made), it is possible to time the payment of equity compensation to coincide with the regular payroll date. In such a case, the equity compensation withholding may be deposited with regular payroll withholding. Likewise, some companies now design restricted stock vesting to fall on a regular payroll date. However, this is not always possible with global plans or in companies with multiple payrolls, or when employees may exercise NQSOs at their own discretion.

If the taxation dates do not fall on the regular payroll dates, but are known pre-scheduled events (such as distribution dates or vesting dates), employers may estimate the probable withholding and deposit the amount with the IRS early or on the date of the payment. If the employer has estimated incorrectly, and is short by less than two percent, the employer may use the shortfall safe harbor for deposit penalties discussed above.

When the company cannot direct or determine the payment dates (such as with options), the employer and payroll company should develop a system that allows them to react quickly when large amounts vest, deferred compensation amounts are paid, or multiple options are exercised.