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IRS Addresses T+2: Settlement Period for Stock Options (Including RSU and SAR Considerations!)

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Companies that use equity-based compensation such as stock options should be aware of a change to the special rules for the deposit of "off-cycle" compensation, keeping in mind that penalties for failing to satisfy these special timing rules exist. This article describes why there will be less time to deposit payroll taxes from stock options, restricted stock units ("RSUs"), and stock appreciation rights ("SARs") in the future.

Stock Option Withholding

Awards of stock options to employees eventually result in employee compensation being subject to federal payroll tax and trigger a 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.

Most large employers are required to deposit federal employment taxes on a semi-weekly basis. However, employers also need to be aware of the "Next-Day Deposit Rule." If, during a payroll period,

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[1] For an in-depth discussion on equity compensation withholding, please see Scott Shapiro, Robert Delgado, Terri Stecher, and Kelli Cacciotti, *Deposits of Federal Employment Taxes for Equity Related Transactions—Pitfalls to Avoid,* What's News in Tax, (Aug. 10, 2020).

an employer accumulates at least $100,000 in federal payroll taxes 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.[2]

There is different treatment under the Next-Day Deposit Rule for nonqualified stock options.[3]

In 2003, the IRS issued an internal field directive addressing stock option exercise and withholding under the Next-Day Deposit Rule.[4] The directive indicated that agents should not challenge a three-day settlement period following the date of exercise of nonqualified stock options, if the deposit is then made the next business day. The directive acknowledged some confusion caused by the interaction between the section 83 rules (which provide that income realized due to the exercise of an option is taxable at the date of exercise) and FICA and income tax withholding rules. In the directive, the IRS noted that under a Securities and Exchange Commission ("SEC") rule, brokers have a maximum of three days for settlement for broker-dealer trades.[5] This rule is commonly known as the "T+3 rule" (the trading date plus three days to settle). Citing this rule, the IRS suggested that agents need not challenge the timeliness of employment tax deposits for stock options, so long as those deposits are made within one day of the settlement period and the settlement period is subject to the T+3 rule.

Changes to the SEC Rule: T+3 Is Now T+2

The SEC issued a final rule to change the settlement period for broker-dealer trades. The final rule, announced March 22, 2017, changes the settlement period for broker-dealer trades from three days from the trading date (T+3) to two days from the trading date (T+2).[6] The SEC indicates a compliance date of September 5, 2017.

The SEC's T+3 rule is specifically cited by the IRS in the 2003 directive as the maximum length of time the SEC allows to settle stock options and thus the corresponding maximum amount of time for the IRS withholding deadline. However, following the release of Generic Legal Advice Memorandum ("GLAM") 2020-004, the IRS released changes to the Internal Revenue Manual section 20.1.4.26.2 in June 2020

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[2] Section 31.6302-1(c)(3). 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] Nonqualified stock options 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 fair market value of the shares on the exercise date and the exercise price.

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

[5] 17 C.F.R. Sec. 240.15c6-1(a). "In fact, under 17 C.F.R. Sec. 240.15c6-1(a), the SEC generally established a maximum three day settlement period for broker-dealer trades….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 date of exercise." IRS Field Directive (Mar. 13, 2003).

[6] SEC 2017-68 (Mar. 22, 2017).

that confirms that the time frame for settlement of stock options is a two day period. The Internal Revenue Manual update likewise extends the administrative waiver to stock-settled SARs and RSUs.

GLAM 2020-004 provides guidance on income tax withholding, and OASDI/Medicare withholding timing and income inclusion, as well as required timing for payroll deposits. The GLAM discusses the administrative waiver granted by the 2003 internal field directive as a three-day settlement rule and indicates that certain stakeholders had previously asked for an extension of the waiver to stock-settled SARs and RSUs, but indicates that the rule is not discussed for purposes of the GLAM. However, the Internal Revenue Manual update released shortly thereafter clarifies that the administrative waiver applies to a two business day period and that the waiver is extended to stock-settled RSUs and SARs.

If—due to the vesting and initiation of settlement of RSUs or an exercise of stock options or SARs—an employer is under the Next-Day Deposit Rule after the effective date of the new SEC rule, it appears that the employer may be required to remit the taxes to the IRS by no later than three days from exercise of stock options/SARs or initiation of settlement of the RSU (two days from exercise to settle the equity award, and the next day to remit the taxes).

The IRS has been successfully collecting penalties for employer failures to timely pay equity withholding under the Next-Day Deposit Rule, so employers should monitor changes to the deadlines and adjust their processes accordingly.

Other Processes Affected

Companies may want to consider a walk-through of settlement and withholding remittance processes to identify these, or other, potential gaps or bottlenecks that could be affected by the T+2 deadline.

Depending on the company's equity administration approach, a company may need to consider small updates to:

- Service level agreements with vendors
- Systems and interfaces
- Communication
- Payroll
- Mobile population documents