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IRS Addresses the Timing of Employment Tax Deposits for Various Stock Awards

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On May 22, 2020, the IRS released an Office of Chief Counsel Memorandum (the Memo) that addresses (i) when income inclusion and the withholding of FICA and federal income taxes apply to stock-settled awards and (ii) the timing for remitting employment taxes for such awards. The Memo takes the position that the fair market value of the stock is measured for inclusion in income (and considered wages for purposes of FICA and federal income tax withholding) on the date nonqualified stock options (NQSOs) and stock appreciation rights (SARs) are exercised and on the date restricted stock units (RSUs) vest, regardless of whether settlement of shares occurs at a later date. (For purposes of the Memo, all awards are stock-settled, no awards are "qualified stock" as defined in IRC Section 83(i), and payment of the RSUs is initiated on the vesting date.) Accordingly, employers subject to the $100,000 next-day deposit rule must deposit the employment taxes associated with NQSOs, SARs and RSUs within one day of the exercise/vest date.

Due to Securities and Exchange Commission (SEC) regulations that apply to transfer agents and securities brokers, there is generally a short delay (settlement cycle) between the exercise of an option/vesting of an RSU and the settlement of the option exercise/RSU payment. The settlement cycle is two business days after the transaction date (or prior to September 5, 2017, was three business days after the transaction), which provides time to sell shares to cover the exercise price/withholding taxes and deliver the shares to the employee's brokerage account in broker-assisted transactions.

The IRS' next-day deposit rule requires employers to remit employment taxes to the IRS within one business day after an employer accumulates $100,000 or more of employment taxes on any given day. Where the next-day deposit rule is triggered by the exercise/vesting of stock awards, should the employment taxes associated with the stock awards be withheld and deposited within a day after exercise/vesting or by the day after the awards are settled? In March 2003, the IRS issued a Field Directive (that was incorporated within its Internal Revenue Manual in January 2012 at IRM 20.1.4.26.2), which instructed IRS examiners not to challenge the timeliness of deposits made within one day of settlement, if the settlement occurred within three days of the stock option exercise (the settlement cycle in effect at that time).

Taxpayers have since requested the IRS extend the administrative relief to SARs and RSUs, which prompted the IRS to revisit the issue. In the Memo, the IRS provides the legal analysis with respect to income inclusion and application of FICA taxes and federal income tax withholding for NQSOs, SARs and RSUs without regard to the administrative waiver of the failure to deposit penalty. The IRS specifically provides in the Memo that the discussion "does not affect application of the administrative waiver described in IRM 20.1.4.26.2."

Reasoning that the employee has an unconditional right to receive the stock upon exercise or vesting and obtained

beneficial ownership of the shares at that time (e.g., risk the shares will decline in value, right to receive dividends and vote the shares, right to transfer or pledge the shares), the IRS determined that the exercise or vesting event triggers taxation. As such, when the next-day deposit rule applies, an employer must deposit employment taxes the day after exercise or vest, even if the employee does not actually receive the shares for a day or two thereafter. Because the IRS specifically provided that the Memo does not affect application of the administrative waiver, it appears the administrative waiver will continue to apply unless and until the Internal Revenue Manual is revised to reflect the guidance in the Memo. However, uncertainty arises with respect to the treatment of SARs and RSUs since the IRM only pertains to NQSOs and the Memo is the only written authority addressing the timing of employment tax deposits for these awards.

As a practical matter, certain employers may not be able to accommodate a next-day deposit rule that is based on the exercise/vest date. A company may not have sufficient cash to pay the employment taxes without first selling the shares to cover such taxes. Where the employee exercising or vesting in the stock award is an executive officer of a public corporation, the employer's payment of employment taxes in advance of actual withholding is a form of a personal loan, which may run afoul of the securities law prohibiting personal loans to executive officers. Companies with mobile employees who worked in several countries during the life of the stock awards may have difficulties sourcing the income, calculating the taxes due among the multi-jurisdictional tax rules and rates, and timely making the deposit by the day after exercise/vest.

Accordingly, the Memo fails to address such issues confronting employers that rely on the administrative waiver to deposit taxes the day after the settlement date without incurring a late deposit penalty. It remains to be seen whether the IRS will expand the administrative waiver by revising the IRM to apply to SARs and RSUs as taxpayers requested, or remove the waiver with respect to NQSOs such that the timing of the deposits on all three award types would be based on the exercise/vest date in accordance with the Memo. To the extent the administrative waiver does not apply, employers should comply with the next-day deposit rule in accordance with the timing set forth in the Memo – the day after exercise/vest. If impractical, the employer should withhold and deposit the taxes by the day after the award is settled and proactively make a showing of reasonable cause to have any late deposit penalties waived.