



Timing of employment taxes for RSUs under current SEC settlement timelines

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In February 2022, the Securities and Exchange Commission (SEC) announced proposals that the U.S. will be moving to a shorter securities settlement cycle from T+2 to T+1. This change is scheduled to occur in May 2024 and follows an earlier reduction five years ago from T+3 to T+2. The SEC indicated that the amended rule was designed to enhance efficiency, reduce risk, and ensure a coordinated and expeditious transition by market participants to a shortened standard settlement cycle (87 Fed. Reg. 10436 [February 2022]).

In parallel, financial institutions have developed more efficient trading platforms, with enhanced technology that allows them to settle trades earlier. While a compressed settlement window may not pose a challenge to those institutions, it does pose challenges to U.S. employers operating large-scale global equity plans, who are required to be tax compliant globally and across a diverse population of domestic and cross-border employees, requiring automated program integrations with brokerage firms to remain compliant. Because the Internal Revenue Service (IRS) through a

nonenforcement policy has adapted the federal employment tax reporting and withholding system to accommodate the required settlement cycle, the further compressed settlement window directly affects the timetables for the related wage payment processing. Further complexities will arise and adjustments to processes will be needed to ensure timely deposits of U.S. employment taxes, in particular when the next-day deposit rules apply. Given the additional time pressures caused by T+1, companies are urged to consider a comprehensive review of their processes to ensure compliance with the next-day deposit rules, and to make other enhancements where necessary.

This article discusses the application of Generic Legal Advice Memorandum (GLAM) dated May 18, 2020 (<https://www.irs.gov/pub/irao/am-2020-004.pdf>) and the nonenforcement policy relief provided under Internal Revenue Manual (IRM) Procedural Update dated May 26, 2020 (sbse-20-0520-0642) to address issues that have arisen for companies in applying the relevant guidance in practice, in particular with respect to restricted stock units (RSUs).

Background: The SEC stock settlement requirements and employment taxes

The SEC rules provide a certain period of time between a payment or issuance of stock and when it is settled as being in the account of a recipient. Currently, the rule provides up to two days for this to occur, although, as noted, the SEC has proposed to allow only one day. For example, if an employee exercises a stock option on a Monday, the current SEC rules would allow the “settlement” of the shares to the employee’s account to not occur until Wednesday. The long-standing issue has been how does this delay on settlement affect the need to withhold and pay (deposit) employment taxes, especially when shares are being withheld and sold to provide the cash to pay the employment taxes, particularly where those shares are being taxed in multiple jurisdictions and tax withholding needs to be calculated and remitted in accordance with foreign tax and payroll rules. Much of the pressure on this issue was relieved in 2003 by the public release of an IRS nonenforcement policy for stock options that permitted the same SEC delay for settlement of the shares to apply for purposes of the deadline for depositing the related employment taxes. And so, for example, the employment tax deposit deadline for stock option exercises could be based on the delayed “settlement date” (the +3 part of the then-applicable SEC T+3 rule) instead of the date of exercise. But that nonenforcement policy addressed only stock options and not other stock compensation such as RSUs and stock-settled SARs, although that compensation raised the same timing issues. In addition, there remained technical issues about when the actual payment date for income tax and employment taxes occurred during the SEC multiday settlement process. Through a recent legal opinion released to the public the GLAM and an expanded nonenforcement policy set out in the IRM applicable to IRS agents, the IRS has attempted to clarify, at least in its view, how employment taxes apply in this context taking into account the SEC stock settlement timing rules. We discuss these further below.

Timing of Taxation: The initiation of payment of stock-settled RSUs

With respect to stock-settled awards, the GLAM discusses the timing of income inclusion and the application of Federal Insurance Contribution Act (FICA) taxes and U.S. federal income tax withholding, and when the employer’s obligation to deposit withheld employment taxes occurs. Specifically, income inclusion occurs on a transfer of property under Section 83, and that is when an employee acquires beneficial ownership interest in such property (stock in this instance). An indication that a stock transfer has occurred is the extent to which the employee incurs the benefits and burdens of ownerships, including the risk that the value of the stock may decline. For stock-settled RSUs, this occurs when the employer “initiates” payment of the RSU.

There is no particular act that constitutes an initiation of payment by the employer; rather it is the employer’s act that begins the process of transferring the stock to the employee. This may be instructions to a transfer agent, a broker, or however the employer commences the process. This is the date that the employee is provided a beneficial interest in the stock, even though it may take a day or two for the stock to arrive in the employee’s brokerage account. Note that while the date the employer commences the transfer process may be the vesting date under the RSU plan, there is no requirement that it be the vesting date and in many cases the date of the initiation of payment will be at a later date than vesting (for example, RSU grants may provide for vesting at retirement eligibility even though for those who are or become retirement eligible, the transfer of the shares may not occur until one or more years later).



Valuation on the date of the initiation of payment (and not vesting)

For U.S. federal income tax purposes, compensation income and wages generally are calculated as the excess of the fair market value (FMV) of the stock transferred over the amount paid for the stock (if any). For purposes of calculating the wages paid to the employee for income tax withholding and reporting purposes, the correct date of valuation is the date of the initiation of payment of the stock-settled RSUs. This may differ from the vesting date, so the vesting date should not be used as the reference point unless the date of the initiation of payment is the same as the vesting date. This is true both for publicly traded stock and nonpublicly traded stock. For publicly traded stock, the valuation should be based on the trading price on the date of initiation of payment. Reasonable methods include the closing price on the day before (as mentioned previously), the opening price on the day of, the closing price on the day of, or some reasonable averaging method based on the trading price on the date of the initiation of payment. Note that for publicly traded stock, this means that the closing price on the day before the initiation of payment may be used including if that immediately preceding date is the vesting date. For administrative purposes, we have seen many companies use the day-before closing price—it's often the most convenient price to use.

The plan rules typically will define any one of these methods for the purposes of calculating the wages, and related federal, state, and local income taxes and FICA taxes. Note for equity transactions that occur outside of the U.S., the definition of FMV may differ in a non-U.S. jurisdiction. For example, in Italy, FMV is defined as “the normal value defined as the average of the FMV closing price of stock for the 30 trading days prior to the date of vest.” Similarly, in India, a formal application needs to be made to a Merchant Banker at the Reserve Bank of India to confirm the “valuation” of the stock which is required for Indian tax reporting purposes. In practice, even if the definition of FMV differs to what is provided in the plan, the administration process with the broker for transaction purposes will still typically use the plan definition of FMV (i.e., generally the U.S. definition). Employers tend to adjust for the FMV in the payroll system to true up any differences in the foreign jurisdiction.

Employment tax deposit deadline may NOT always be third day after initiation of payment

The IRS relief provided for stock-settled RSUs is based on the date of settlement in the employee's brokerage account. If the stock arrives in the employee's brokerage account the day after payment is initiated (T+1), then the deposit deadline relief only extends one additional day (T+2) and a deposit on the third day would be one day late. Many brokers have increased their capability to transfer stock to the employee's account the day after the instructions are provided to initiate the transfer, especially when those instructions are given early in the day. Accordingly, employers should have discussions with their brokers to ensure that they know the applicable deadline for employment tax deposits to avoid any potential penalties.

In practice, meeting the \$100,000 next-day deposit deadline remains a pain point for many employers, particularly those running large-scale global equity programs, purely due to their ability (or inability) to perform tax withholding and reporting accurately in accordance with global tax logic and the Organisation for Economic Co-operation and Development principles on determining the country that has the right to tax. Broker systems have become more efficient in administering and processing equity awards, but many employers, particularly those who do not have automated feeds with their broker and payroll vendors, do not

have the ability to manage the compliance end of the process. This often results in confusion between brokers and the companies they service regarding which date is the required settlement date for next-day deposit purposes, with brokers typically believing it occurs earlier while companies need it to occur later to provide more time to accurately process in payroll.

The IRS informally has been made aware that the historic linkage between the employment tax deposit deadline relief and the SEC settlement date deadlines may not provide sufficient time to process the payroll and employment tax deposits if and when the SEC settlement date deadline is shortened to one day. In essence, even if the stock can be settled to the employee's account within one day, employers are finding that the administrative process for employment taxes may take an additional day (if not longer). It remains to be seen whether the IRS will expand the current relief that would provide only a single day relief, especially before the proposed SEC T+1 deadline is finalized and put into effect. Therefore, employers should coordinate with their stock plan administrators to ensure they are aware of the settlement process and timing and how it may affect deadlines for the payroll and employment tax process.



Application of employment tax deposit deadline relief to net-settled RSUs

Historically, the IRS relief related to stock compensation and employment tax deposit deadlines does not distinguish between stock transfers for which shares are sold to cover the employment taxes and stock transfers for which only the postwithholding shares are transferred to the employee and the employment taxes are paid from the employer's cash (e.g., net-settled stock options and now RSUs). This has led to confusion about whether the employment tax deposit deadline relief applies to net-settled RSUs even though shares are not sold in that circumstance. Clarification has been requested, but the IRS has yet to officially respond. More recently, IRS officials have informally indicated that since the current IRM relief does not make any distinction, it applies whether or not there is a sale to cover. While there is no official clarity, employers who make payments as net-settled RSUs may, in the meantime, want to ensure that employment taxes are deposited based on the payment initiation date if possible (meaning not taking advantage of the IRS relief and instead prearranging for the deposit to be made on the day after the RSU payments are initiated for a next-day depositor). In order to meet the compressed T+1 settlement window, employers may prefer a net settlement of stock awards going forward, as this will enable them to fund withholding taxes up front, and not have to wait for withholding monies to be provided by the stock plan administrator once the trade is settled.

T +1 for stock-settled compensation will add pressure for U.S. next-day deposit rule

To manage in practice the employment tax process with stock-based compensation, some employers make estimated payments of applicable withholding taxes to ensure they meet the next-day deposit deadline, and then make an adjustment or true-up to actual amounts, if needed, within the same payroll period to avoid penalties. The time pressures will be exacerbated with the proposed introduction of a T+1 settlement window. Stock options may be particularly challenging to process timely and accurately because an employer does not know when an employee may send in a notice of exercise, and without an automated equity process, meeting a T+1 settlement deadline for stock options often is not possible, particularly when services have been performed in more than one jurisdiction.



Section 941 Reporting – Form and instructions do not incorporate IRS relief

The IRM relief does not change the wage payment date, but rather instructs IRS agents not to assert deposit penalties if the related employment tax deposits are made with an additional one or two days after the otherwise applicable next-day deposit deadline (as discussed above). The current Form 941 instructions require that wage payment dates be reported but provide no specific reporting box on the Form 941 or other mechanism to report deposits of employment taxes related to equity awards, and to indicate that the relief has been relied upon. This has raised the potential for a circular process of IRS notification of untimely deposits, employer replies indicating the applicability of the relief, and then IRS processing to avoid improper assertions of penalties. While some employers have used self-help to report the wage payment date based on the settlement date as a means of indicating that the related employment tax deposit was not late, this would not seem to be consistent with the current guidance on wage payment dates or the instructions to the form. The IRS informally has been made aware of the potential for this burdensome and wasteful (to both parties) resolution process and has indicated they are looking at whether changes to the form or instructions or some other process changes could eliminate this potential. Until then, employers may want to keep available the records of the particular wage payments for which the relief was utilized in case they are needed to respond to any IRS inquiries.



Conclusion

In conclusion, we highly recommend developing a process timeline of your equity administration process and settlement windows in agreement with tax service providers and your stock plan administrator to determine where there may be risk in meeting processing timelines, and to enable a company to develop appropriate solutions to manage compliance.



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