

New Planning Opportunities Inspired by IRS Memo on Taxation of Equity Awards

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Synopsis

The Internal Revenue Service (IRS) released a [Generic Legal Advice Memorandum, GLAM 2020-004](#) (the IRS Memo) dated May 18, 2020 addressing the timing of income and payroll tax withholding on three types of employee equity awards: nonqualified stock options (Options), stock-settled stock appreciation rights (SARs), and stock-settled restricted stock units (RSUs).

For publicly traded companies, the IRS Memo clarifies that Options and SARs are taxable when exercised, even though shares may not be delivered to the employee's brokerage account for up to two days after exercise. This conclusion should be unsurprising to most employers.

More interestingly, the IRS Memo states that RSUs are treated as taxable when the employer "initiates payment" of the RSUs to employees. This "initiates payment" standard for RSUs appears to be a new concept and could prove helpful to some employers. This article explores some planning opportunities for employers related to this standard.

The Basics of Options, SARs, and RSUs

Options, SARs, and RSUs have the following basic features:

- An **Option** is a contractual right, granted by an employer to an employee, for the employee to purchase a fixed number of employer shares at a fixed price (the exercise price) during a fixed period of time (the option term). The exercise price is typically the fair market value of the shares on the grant date, and the option term is usually 10 years (or less due to termination of employment). An employee's right to exercise is usually conditioned on meeting vesting requirements specified in the award agreement. To exercise the Option, the employee normally must provide a written exercise notice plus payment in full of the exercise price. The employee must also provide funds to satisfy all tax withholding obligations (discussed further below).^[1]
- **SARs** are economically similar to Options, but do not require the employee to pay an exercise price. Instead, SARs entitle the employee to receive upon exercise the difference between the value of the underlying shares on the date of exercise and the SAR "base price," which (like the Option exercise price) is typically the fair market value of the shares on the grant date. For a stock-settled SAR, this spread in value upon exercise is paid by delivery of a number of shares equal in value to that spread. The IRS Memo addresses only stock-settled

SARs.

- An **RSU** is a contractual right of an employee to receive a specified number of the employer's shares at a later date, after satisfying any applicable vesting requirements. The vesting requirements could include continued employment through scheduled vesting dates (sometimes referred to as "time-vesting" RSUs) and/or achievement of performance goals (sometimes referred to as "performance-vesting" RSUs, or **PSUs**). The employee pays no exercise price. The date the shares are to be paid is often the date the vesting requirements are met, but can also be a later specified date. The design of RSUs needs to consider compliance with the deferred compensation rules under Internal Revenue Code Section 409A and the "special timing rule" for FICA taxes (i.e., Social Security taxes up to the Social Security wage base plus Medicare taxes), especially if the payment date can occur in a later year after the vesting date.^[2]

When a taxable event for an Option, SAR, or RSU occurs for an employee, the employer must determine the amount of taxable income that will be included in the employee's W-2 taxable wages for the year. The employer also must withhold all applicable federal, state, and local income taxes and applicable FICA taxes.^[3] The IRS Memo addresses how and when these taxable wages and withholdings are determined.

Timing and Amount of Taxation Per the IRS Memo

For public companies, there is usually a brief delay between when Options and SARs are exercised and when shares are actually delivered to the employee (usually into a brokerage account with a third-party administrator for the employer's equity compensation plan). A similar delay can occur between the date that an employer starts the process to issue shares in payment of an RSU and the date that the shares are actually delivered to the employee's brokerage account.

The IRS Memo addresses when the taxable event is considered to have occurred for these transactions. The date of the taxable event is important for at least two reasons:

- determining the fair market value of the shares to determine the amount of taxable income, and
- determining when tax withholding deposits are due.

The IRS Memo includes examples for each type of award.

For Options and SARs, taxation occurs upon exercise. In the examples in the IRS Memo, if an Option with an exercise price of \$10 is exercised on Day 1 when the stock has a fair market value^[4] of \$25, the amount of taxable income is \$15 (i.e., \$25 – \$10). This calculation applies even if the shares are not actually delivered to the employee until Day 3, and even though on Day 3 the stock is worth \$24. In accordance with the IRS Memo, once the exercise has occurred, the employee is considered to have beneficial ownership of the shares to be delivered, because the employee stands to participate in any increase or decrease in the value of those shares after exercise.

As noted above, there is no exercise date for RSUs. According to the IRS Memo, the tax date for RSUs is the date that the employer “initiates payment.” As in the examples for Options and SARs, if the shares are worth \$25 on Day 1 when the employer initiates payment of vested RSUs, that \$25 value will be the price used to determine the amount of income taxes and withholdings for the RSUs, even though the shares are not actually delivered to the employee until Day 3 when the shares are worth \$24. Similar to the analysis for Options and SARs, the IRS concludes that the employee has beneficial ownership in the shares once payment has been initiated by the employer.

The IRS Memo does not expressly define what “initiates payment” means, but indicates that a public company initiates payment when it instructs its transfer agent to transfer shares to the employee’s brokerage account.

Many employers will initiate payment for an RSU on the scheduled vesting date. This approach is especially common for typical time-vesting RSUs. In those cases, the vesting date fair market value of the shares will determine the amount of taxable income and withholdings. This result likely represents no change in practice for many employers.

But the design of some RSUs will require the recognition of income on dates other than the vesting date.^[5] For example, many RSUs provide for payment within a specified period (e.g., 30 days) following the applicable vesting date. PSUs often provide for payment during a period (e.g., 2 ½ months) following the end of the applicable performance period and after performance results have been certified. In these cases, employers will have flexibility in determining when to initiate payment within the stated period, and the employer’s decision as to the date that the payment is initiated will determine the date of income inclusion according to the IRS Memo.

Unlike Options and SARs, RSUs can also have deferred payment dates, subject to compliance with Section 409A. If a deferred RSU is payable on a future fixed date or permissible payment event (such as termination of employment), the taxable amount and withholdings should be based on when the employer initiates payment following that permissible payment date or event.^[6]

Interplay with One-Day Rule

The IRS Memo reaffirms that the deposit of employment taxes (i.e., both required income tax withholdings and FICA taxes) must occur within one business day after the relevant tax event for Options, SARs, and RSUs if the employer has accumulated \$100,000 or more in employment taxes during a monthly or semi-monthly deposit period (the One-Day Rule). The IRS Memo confirms that the clock for the One-Day Rule starts on the day of exercise for Options and SARs and the day the employer initiates payment for RSUs, so that employment tax deposits are technically due the following business day.

The One-Day Rule can present a challenge for public companies when (i) shares from the award are sold by the employee on the date of Option/SAR exercise or RSU payment to fund required tax withholding, but (ii) the proceeds of the same-day sales are not deposited until two days later, consistent with “T+2” settlement requirements under current Securities and Exchange Commission (SEC) rules. The IRS previously issued a 2003 Field Directive in which it directs agents to not assert penalties on employers that fail to satisfy the One-Day Rule in connection with Option exercises if the employer deposits employment taxes within one day after settlement of the shares, assuming settlement occurs within three days after exercise (consistent with the SEC’s “T+3”

settlement requirement that applied at that time).

The omission of SARs and RSUs from the 2003 Field Directive was not especially significant or surprising at that time, as those award types were not common then. Since then, however, the popularity of RSUs has increased substantially and the absence of relief for RSUs from the One-Day Rule has become a practical problem for some employers.

Thankfully, immediately after publication of the IRS Memo, the IRS revised its Internal Revenue Manual field agent guidance to provide relief from the One-Day Rule for SAR exercises and RSU payments, as well as Option exercises. The revision states that agents may waive otherwise applicable late deposit penalties if employment taxes are deposited within one business day after the “T+2” settlement date for SARs and RSUs, as well as Options.^[7]

Planning Opportunities for Employers

The new “initiates payment” standard for the timing of taxation for RSUs may present employers with planning opportunities. Some of the possible planning opportunities include:

- having a single payment date for administration of tax reporting and withholding for RSUs and PSUs that vest on multiple prior days during a year,
- timing the payment date to be during an open trading window (e.g., three days after public release of quarterly or annual financial statements), and
- timing the payment date in coordination with dividend record dates (e.g., so that the shares delivered in settlement will qualify to receive the dividend).

For example, assume an employer has time-vesting RSUs that vest on February 12, 14, and 15 during 2021. Assume there is also a PSU award with a 2018-2020 performance period that the compensation committee, at its meeting in February 2021, determines was earned at target. Assume the employer plans to file its 10-K at the end of February, with an open trading window under their insider trading policy starting on March 4. If the award agreements include language permitting the employer to pick a payment date within a specified administrative period (e.g., on a day no later than March 15, 2021), the employer could select March 4 as the payment date for all of these awards and initiate payment on that date. This single payment date for the various awards could provide several potential benefits, such as:

- simpler administration for tax reporting and withholding (e.g., by having a single stock price to value all of the awards for tax purposes);
- if share withholding is used to cover taxes for Section 16 officers, simpler Form 4 filing requirements (with a single Form 4 reporting those share withholding transactions for each Section 16 officer); and
- if tax withholding is to be covered through employee-directed broker sales of shares subject to the awards,

simpler compliance with insider trading policy requirements (i.e., by having the sale transactions executed during an open window).

Public companies looking to conserve cash during the economic crisis created by COVID-19 may also want to consider greater use of broker sales to cover tax withholding obligations related to stock-settled SAR exercises and RSU payments. Previously, this approach was not possible without exposing the employer to late deposit penalties or without the employer using its cash to advance the proceeds expected from employee-directed broker sales. The recent IRS clarification about application of the One-Day Rule to these transactions (described above) will facilitate timely tax deposit using this approach.

Conclusion

While the IRS Memo likely does not change the tax reporting and withholding practices as to Option and SAR exercises for most public company employers, it does present some planning opportunities regarding the settlement of vested RSUs and PSUs. Employers may wish to review their RSU and PSU awards agreements and related tax administrative practices and consider whether any changes are appropriate or desired.

[1] A “statutory option” or “incentive stock option” (an ISO) is a special kind of stock option that meets certain technical requirements under the Internal Revenue Code, and provides employees with special tax benefits. The Options discussed in the IRS Memo are not ISOs, but are “non-qualified stock options” that are generally taxable upon exercise.

[2] Options and SARs are usually designed to be exempt from the requirements of Section 409A. When RSUs vest in one year but are paid in a later year, FICA taxes are usually due in the year of vesting, even though income taxes are not due until the year of payment. This is sometimes referred to as the FICA tax “special timing rule.”

[3] See footnote 2 regarding the FICA tax special timing rule that sometimes applies to RSUs, depending on the design. The guidance in the IRS Memo does not change the special timing rule. The examples in the IRS Memo related to RSUs were designed so that income and FICA taxes became due at the same time.

[4] Public company employers have some flexibility in how the fair market value of the shares are determined at the time of exercise for purposes of calculating taxable income. Employers may use any reasonable method for determining fair market value for income recognition purposes. Depending on the facts and circumstances, these methods may include closing price on the day of the taxable event, closing price for the prior day, an average of high and low prices, or a trailing average of prices over a number of days. Any such approach should be properly documented and consistently applied.

[5] Such award features must be designed carefully to achieve compliance with, or exemption from, Section 409A.

[6] But see footnote 2 above regarding the FICA tax special timing rule that may require assessment of FICA taxes on RSUs in the year of vesting rather than at the later, deferred payment date.

[7] See IRM 20.1.4.26.2(5), “Expanded instruction to NSO, stock-settled SAR, and stock-settled RSU. Clarified time frame for settlement,” issued May 26, 2020.

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