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Publications

New SEC T+1 Rule Further Tightens Payroll Deposit Timeline for Stock Options and RSUs

ATTORNEYS & PROFESSIONALS

William Fogleman
wfogleman@groom.com
202-861-6619

Emily Gerard
egerard@groom.com
202-861-9375

Jeffrey W. Kroh
jkroh@groom.com
202-861-5428

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Employers who compensate employees through nonqualified stock options or restricted stock units ("RSUs") should be aware of an upcoming Securities and Exchange Commission ("SEC") **rule change** affecting the settlement of securities transactions. Effective May 28, 2024, this new rule will require most securities transactions to be settled within one business day after the trade date. The SEC calls this the "T+1" settlement cycle, in contrast to the prior, more generous "T+2" cycle, which allowed for two business days to settle a securities transaction. This new move echoes a similar rule implemented in 2017, when the SEC shortened the standard settlement cycle from T+3 to T+2.

For employees exercising stock options or receiving payment of RSUs in employer stock, the T+1 rule means that the shares of stock must be deposited into the employee's brokerage account within one business day after the trade date. As discussed below, the T+1 rule also reduces the amount of time many employers will have to withhold and remit federal employment taxes (*i.e.*, income and FICA taxes an employer is required to withhold) on such shares.

Withholding Taxes on Shares of Stock

The Internal Revenue Service ("IRS") imposes strict timing requirements for withholding and remitting employment taxes on employees' wages (which include stock options and RSUs). Generally, employers who accumulate more than $100,000 in employment taxes on any day must deposit such taxes with the IRS by the next business day. Most large employers are subject to this "next-day" deposit rule. (Smaller employers may be required to deposit employment taxes on a monthly or semi-weekly basis.)

The federal employment tax rules generally apply regardless of whether the wages are paid in cash or in property (such as shares of stock). However, the IRS requires employers to deposit employment taxes in cash. Thus, employers who pay employees in shares of stock must make advance arrangements to ensure the employee is able to provide the employer with the cash necessary to satisfy the employee's share of employment taxes by the applicable deposit deadline. Common approaches include:

- *Netting shares*: Delivering a reduced number of shares to reflect employment taxes owed on the payment.

- *Selling to cover*: Delivering the full number of shares and immediately selling a portion to generate cash for employment taxes.
- *Paying with cash*: Delivering the full number of shares and paying the employer cash from other sources to satisfy employment taxes.

Penalties

Employers who fail to deposit employment taxes by the applicable deadline face penalties based on the number of calendar days the deposit is late: a 2% penalty for deposits one to five days late; a 5% penalty for deposits six to 15 days late; and a 10% penalty for deposits 16 or more days late. In addition, if the IRS notifies the employer of the deficiency, the penalty increases to 15% if the deposit is not paid within 10 days following the notice date. Notably, the IRS calculates its penalties for late deposits based on calendar days, not business days.

Impact of T+1 Rule on Withholding Practices

The T+1 rule generally will reduce the amount of time an employer has to withhold on wages paid in the form of shares of stock. Generally, for purposes of the employment tax deposit rules, the IRS considers a share of stock to be "paid" to an employee when the stock transaction is settled. (See Generic Legal Advice Memorandum ("GLAM") 2020-004.) In recognition of the SEC's existing T+2 rule, the IRS has indicated in guidance that it will not consider a next-day rule employer to be late on a stock-related deposit until after the third business day following the trade date (*i.e.*, the "next day" following the end of the T+2 period). (See Internal Revenue Manual 20.1.4.26.2(5)(d).)

Under the new T+1 rule, employers will be required to settle a stock payment within one business day after the trade date. Thus, it follows that under the "next day" rule, employment taxes associated with stock payments must be paid by the second business day following the trade date.

To illustrate: Assume the trade date for a stock award subject to the next-day rule is Wednesday, May 29, 2024. Under the prior T+2 rule, the stock payment would need to be settled by Friday, May 31, and employment taxes on the award would need to be deposited by Monday, June 3. However, under the T+1 rule, the stock payment must instead be settled on Thursday, May 30, and employment taxes must be deposited on Friday, May 31, 2024. If an employer is unaware of the settlement date change and deposits the employment taxes on June 3, the employer will face a 2% penalty on the late deposit.

Key Takeaway

The new SEC T+1 rule goes into effect on May 28, 2024, tightening the timeline for employers to calculate, withhold, and deposit employment taxes for vested stock options and RSUs. To avoid penalties, employers should ensure their payroll systems and stock plan providers are updated and ready for this change.